TAX MANAGEMENT

PORTFOLIOS

The Tax Reform Act of 1986
Volume II
Detailed Analysis



How to Order Additional Copies

Additional copies of Portfolio 986, *Tax Reform Act of 1986, Volumes I* and *II*, are available to subscribers at the following rates and multiple copy discount:

Number	Discount	Price per set
1 - 9	50%	$50.00
10 or more	60%	$40.00

To place your order, write or call:

TAX MANAGEMENT INC.
A Subsidiary of The Bureau of National Affairs, Inc.
Attn: Customer Service, Dept. P
1231 25th Street, N.W., Washington, D.C. 20037

Call Toll-Free: 1-800-372-1033

TAX MANAGEMENT

The Tax Reform Act of 1986

VOLUME II

Detailed Analysis

This volume is the second part of a comprehensive, two-volume portfolio featuring legislative history and detailed analysis of the Tax Reform Act of 1986, enacted October 22, 1986. Volume I, the series' legislative history component, contains full text of the House, Senate, and Conference Reports plus the final version of the Act. Volume II is a compendium of analysis written by active practitioners. It includes discussion of significant post-Act developments occurring through December 31, 1986.

Leonard L. Silverstein, Chief Editor

© 1987 TAX MANAGEMENT INC., a subsidiary of The Bureau of National Affairs, Inc.
1231 25th Street, N.W., Washington, D.C. 20037

Tax Management Inc.,
makes available the following professionally oriented publications:

TAX MANAGEMENT

Weekly Report
U.S. Income Series
Memorandum
Estates, Gifts, and Trusts Series
Estates, Gifts, and Trusts Journal
Estates, Gifts, and Trusts Reference File
Foreign Income Series
International Journal
Compensation Planning Series
Compensation Planning Journal
Real Estate Series
Real Estate Journal
Primary Sources
Washington Tax Review
Financial Planning
Financial Planning Journal

For Information . . .
call TOLL FREE: 1-800-372-1033

© 1987 TAX MANAGEMENT INC., a subsidiary of The Bureau of National Affairs, Inc.
1231 25th Street, N.W., Washington, D.C. 20037

TAX MANAGEMENT

The Tax Reform Act of 1986
Volume II
Detailed Analysis

Prepared By

The Law Firm of
Silverstein and Mullens
Washington, D.C.

EDITORIAL BOARD

Editor-in-Chief
Leonard L. Silverstein, Esq.

Deputy Chief Editor
Gerald H. Sherman, Esq.

Chief Associate Editor
Javed A. Khokhar, Esq.

Deputy Chief Associate Editor
Patrick G. Dooher, Esq.

Silverstein and Mullens

Richard A. Mullens, Esq.
Robert E. Falb, Esq.
Jerry J. McCoy, Esq.
Adelbert L. Suwalsky, Jr., Esq.
Stuart M. Lewis, Esq.
Ronald D. Abramson, Esq.
Lynn K. Pearle, Esq.
John P. Warner, Esq.
Robert E. Liles, II, Esq.
Donald B. Reynolds, Jr., Esq.
Charles E. Taylor, Esq.
Diane J. Fuchs, Esq.
Brant Baber, Esq.
Harrison B. McCawley, Esq.
Donald J. Mathison, Esq.
Patricia R. Lesser, Esq.
Deborah M. Beers, Esq.
James F. Miller, Esq.
John Freeman Blake, Esq.
Samuel M. Maruca, Esq.
John F. Lefevere, Esq.
Jane M. Eldredge, Esq.
Taina E. Edlund, Esq.
George B. Delta, Esq.
Marilyn E. Nelson, Esq.
Margo B. Stern, Esq.
Steven C. Wallace, Esq.

Edited By

The Staff of Tax Management Inc.

Associate Editor
Patrick M. Rockelli, Esq.

Managing Editor
Glenn B. Davis, Esq.

Assistant Managing Editor
Virginia A. Shew

Staff Editors

C. Bruce Combs
Frank M. Cunat, Esq.
John E. Donihee, Esq.
Jeffrey A. Kolender, Esq.
Michael G. Kushner, Esq.
M. Briere Taylor, Esq.
Ellen V. Ruggieri, Esq.
Marc H. Sassin
Nancy Williams
Kathleen M. Wise, Esq.

© 1987 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ACKNOWLEDGMENT

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

John T. Adney *
Dennis L. Allen **
Brant Baber
Deborah M. Beers
John Freeman Blake
William S. Corey **
George B. Delta
Patrick G. Dooher
Taina E. Edlund
Jane M. Eldredge
Diane J. Fuchs
William B. Harman, Jr. *
Andrew E. Huddleston
Javed A. Khokhar
John F. Lefevere
Patricia R. Lesser
Stuart M. Lewis
Robert E. Liles
Samuel M. Maruca
Harrison B. McCawley
Jerry J. McCoy
Joseph F. McKeever, III *
James F. Miller
Clifford E. Muller **
Marilyn E. Nelson
Lynn K. Pearle
Lloyd Leva Plaine **
G. Garner Prillaman **
Donald B. Reynolds, Jr.
Lucia N. Smeal
Margo B. Stern
Adelbert L. Suwalsky, Jr.
C. David Swenson ***
Charles E. Taylor *
Leonard B. Terr **
Christine L. Vaughn ****
Steven C. Wallace
John P. Warner
Gail B. Wilkins

Project Coordinator

Diana Luehring

* Davis and Harman, Washington, D.C.
** Sutherland, Asbill & Brennan, Washington, D.C.
*** Baker & McKenzie
**** Vinson & Elkins

© 1987 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The Tax Refom Act of 1986

VOLUME II

TABLE OF CONTENTS

Foreword ..... (vii)

Legislative History of the Tax Reform Act of 1986 ..... (ix)

Table of Contents: Detailed Analysis ..... (xiii)

Detailed Analysis 1:1

Key Word Index: Detailed Analysis A:1

Table of Principal Internal Revenue Code Sections Added, Amended, or Repealed by the Tax Reform Act of 1986 ..... B:1

© 1987 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

FOREWORD

The Internal Revenue Code of 1986

"Poundage" alone—more than 1000 pages of fresh and necessarily intricate statutory language—underscores the fact, now a virtual cliche, that the Tax Reform Act of 1986 represents the most profound revision of the Internal Revenue Laws of the United States since the enactment of the income tax.

The sea of changes in tax policy—enacted under banners of equity, neutrality, and simplification—are reflected in the bold alterations of the tax structure. These include the elimination of the capital gain-ordinary income differential, the repeal or modification of a host of socially or economically motivated deductions, as well as a dramatic and welcomed lowering of tax rates. These changes do indeed validate characterization of the new law as "fundamental" tax reform.

Viewed from the standpoint of the active tax professional, however,—the perspective which is the concern of this volume—it is evident that a very demanding agenda emerges. Early in the two-year gestation of the legislative process which actively began with the publication of so-called Treasury I, it became readily apparent that the announced goal of simplification was to be sacrificed, at least with respect to middle- and upper-income taxpayers as well as with respect to corporate and noncorporate businesses. The base broadening objectives of the new Code incorporate mechanisms which make it essential to renew and possibly recast taxation of business structures. In this respect, another of the announced objectives of the new law—tax neutrality—has fallen in response to a frenzy of tax-motivated activity generated by 1986 measures.

Coupled with all of the foregoing is the critical problem of administration of, and compliance with, newly articulated tax policies. In past years, as revenue acts have proliferated almost annually, the process of promulgation of regulations and other official interpretative materials has seriously lagged behind the need for their usage. This year the lag has become greater than ever. In consequence, the federal income tax effects of countless business and personal transactions must be evaluated against a background of ambiguities, which inevitably derive from the legislative process and for which there is all too often no perfect response. To an extent not heretofore encountered, the private sector is needed to assist in the interpretation and application of the statute. In light of the above, Tax Management wishes to assure its audience that it recognizes the magnitude of its responsibility to the increasingly wide audience which depends upon the content of our publications. As the publication of this Volume II, (together with the accompanying legislative materials in Volume I) indicates, Tax Management will spare no effort to mobilize its resources to aid in the great task of comprehension and responsible tax compliance.

In our efforts, we have been materially aided through discussions with colleagues and governmental persons in appropriate situations. In this volume we have endeavored to incorporate these dimensions of understanding and implication to the general outlines of the new law. Because this Volume follows the distribution of our "Precis Reviews" of the 1986 Act (already integrated into the portfolio series), we have also here attempted, where feasible, to enrich our interpretation of the new rules with the benefit of the "in practice" experiences. Your attention is directed particularly to discussions of the alternative minimum tax, employee benefits, rules affecting real estate (including passive losses and REMIC's) as well as the in-depth treatment of business capital expenditures, accounting methods and periods, and the international provisions. As occurs with all Tax Management publications, we welcome and encourage constructive commentary from our ever-growing family of users. These will be incorporated in later materials, as our experience in application of the new law matures.

The publication of this volume would not have been possible without the highest degree of cooperation and commitment from the firm of Silverstein and Mullens and their colleagues with the dedicated staff of Editors at Tax Management. We look forward eagerly to your comments as we continue our efforts to fulfill our responsibility to the tax profession.

Leonard L. Silverstein
Chief Editor

© 1987 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

LEGISLATIVE HISTORY OF THE TAX REFORM ACT OF 1986

John F. Kelly, Jr., Esq.
Silverstein and Mullens
Washington, D.C.

The Tax Reform Act of 1986, introduced as H.R. 3838 on December 3, 1985, was a product of an extraordinary legislative history that cannot be traced through the usual channels. Unlike the progress of most legislation, the concepts incorporated in the final version of the tax reform bill can be directly credited to a number of sources, from the Administration, to Congress, to lobbyists and, finally, to ordinary citizens.

Early Tax Reform Bills

Major themes found in the final version of TRA 1986 are evident in a number of earlier bills which never made it very far through the legislative process. A few of the most significant reform measures were, in fact, introduced several times in different Congresses to continually address the need for comprehensive tax reform.

Included in the early initiatives introduced in Congress were:

S. 2817 — "Fair Tax Act of 1982," introduced on May 27, 1982, by Sen. Bill Bradley (D-NJ). The same version was introduced in the House of Representatives by Rep. Richard Gephardt (D-MO) as H.R. 6944. Without much success, the pair continually reintroduced their tax bills, again in 1983, and 1985. (*See:* S. 409 and H.R. 800 in the 99th Congress.) Although there was little legislative action on the Bradley-Gephardt bill, its policy of rate reduction and base broadening by elimination of most credits, deductions and exclusions was adopted in future efforts.

H.R. 777 — "Fair and Simple Tax Act of 1985" (FAST) was introduced on January 30, 1985 by Rep. Jack Kemp (R-NY), with an identical bill (S. 325) introduced by Sen. Bob Kasten on January 31, 1985. Similarly, Kemp-Kasten sought fairness through rate reduction and eliminating tax breaks. Slightly revised versions of the bills were introduced on April 25, 1985 as H.R. 2222 and S. 1006, with changes in the earned income credit and the treatment of intangible drilling costs.

H.R. 373 — "Broad Based Enhanced Savings Tax Act of 1985" was introduced by Rep. Henson Moore on January 3, 1985. The same bill was introduced by Sen. William Roth (R-DE) on January 21, 1985.

Interest in tax reform was hardly novel. Differences arose, however, in the proper approach to tax reform and over how the idea of lower rates and fewer deductions was to be achieved. Most agreed that the Internal Revenue Code of 1954 needed a massive overhaul. Ironically, it may have been the prospect of such a task that prompted Sen. Bob Packwood (R-OR), one of the eventual champions of tax reform, to state that he liked the Code the way it was.

Treasury and Administration Proposals

Despite the number of tax reform initiatives offered by Congress, most observers agree that passage of tax reform was ultimately the result of President Ronald Reagan's insistence. In his State of the Union address on January 25, 1984, he called for then Secretary of the Treasury Donald T. Regan to develop a tax plan to promote fairness and simplification. It was not until after the President's successful bid for a second term in office that Treasury would release its *Tax Reform for Fairness, Simplicity and Growth* on November 27, 1984. The three-volume proposal became more popularly known as Treasury I, the predecessor to a later Administration proposal. Although never adopted as Administration policy, Treasury I would serve as the blueprint for future tax reform efforts. It bore a strong resemblance to the Bradley-Gephardt bill, introduced almost two years earlier.

Before the next major push for tax reform, a surprising job swap was made in the Administration. On January 8, 1985 White House Chief of Staff James A. Baker, III, and Treasury Secretary Donald T. Regan announced their intention to switch positions. The move placed James Baker in the position of pointman for the Administration on tax reform.

In his next State of the Union Address on February 6, 1985, President Reagan declared tax reform to be first on his list of domestic priorities. As a result, the House Ways and Means Committee, chaired by Rep. Dan Rostenkowski (D-IL), began a series of hearings on tax reform on February 27, 1985. Later, on May 9, 1985, Sen. Bob Packwood (R-OR) began hearings in the Senate Finance Committee. Hearings at this point, however, were preliminary in anticipation of a revised Administration proposal known to be in the works. Testimony focused on broad tax policy issues and tax reform proposals already introduced.

On May 28, 1985, the Reagan Administration unveiled the *President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*. The long-awaited plan was offered in an address to the nation and served as the starting point for legislation developed during the next one and one-half years. The new proposal, referred to as Treasury II, was considered a more politically palatable version of Treasury I.

© 1987 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

House Bill Emerges

Almost immediately, responsibility shifted to Ways and Means Chairman Rostenkowski, who was eager to make his mark on this major piece of legislation. Hearings in his Committee resumed on May 30, 1985. Treasury Secretary James Baker was first in the long line of witnesses appearing before the Committee. After 28 days and close to 450 witnesses, hearings came to a close in the Ways and Means Committee on July 31, 1985. [Serials 99-41 through 99-49 *Comprehensive Tax Reform*, Hearings Before the Committee of Ways and Means (Parts 1-9)].

Similarly, the Senate Finance Committee began to hold hearings on the President's proposal on June 11, 1985. [S. Hrg. 99-249, Volumes 1-27 *Tax Reform Proposals* (June 11 through October 10, 1985)].

Attention, however, focused on the House side where the Ways and Means Committee began mark-up on its own proposal. Chairman Rostenkowski introduced his own plan to the Committee as the mark-up vehicle. [JCS 44-85, *Tax Reform Proposals in Connection with the Committee on Ways and Means Mark-up*, September 26, 1985.]

The Committee began mark-up in closed executive sessions, which were often attended by Treasury officials. The sessions were off to a shaky start as members refused to give up their favored tax breaks. As the panel started voting to retain costly tax breaks the bill was, at the very least, ailing. It was not until Chairman Rostenkowski began dealing with individual members, exchanging pet provisions for support for the entire proposal, that momentum for tax reform was restored.

On November 23, 1985, the Ways and Means Committee approved a compromise proposal at about 4:00 in the morning with a partisan 28-9 vote. All nine dissenting votes were from Republicans. Nearly a week later, the proposal was introduced on the House floor. [H.R. 3838, *The Tax Reform Act of 1985, as Reported by the Committee on Ways and Means*, December 3, 1985; H.R. Rep. No. 426, 99th Cong., 1st Sess., *Committee on Ways and Means Report on H.R. 3838*, December 7, 1985. The House Report is reproduced in Volume I of this portfolio.]

Also introduced by Rep. John Duncan (R-Tenn.) was a proposal called the "Republican Alternative" co-sponsored by a number of Ways and Means Republicans who opposed the Committee bill. [H.R. 3879, *Tax Fairness and Reform Act*, December 9, 1985.] The bill received only minor consideration on the House floor.

The next threat to the survival of tax reform was a dramatic Republican revolt on the House floor. After the President offered only lukewarm support for the bill, the House voted 223-202 on December 11, 1985, to reject the modified closed rule (H. Res. 336) preventing the legislation from coming to the floor. Only 14 Republicans voted in favor of the rule.

With his political clout on the line, the President made a rare appearance on Capitol Hill to urge House Republicans not to kill tax reform, vowing to insist upon certain changes in the Senate. On December 17, 1985, after some serious head counting and a new rule (H. Res. 343), the House voted 256-171 to allow debate to begin. Strangely enough, final passage of the bill occurred on a voice vote, an unusual procedure for a controversial piece of legislation. Opponents never called for a recorded vote, perhaps because the House floor was in disarray. [H.R. 3838, *Tax Reform Act of 1985*, as Amended by the House of Representatives, December 17, 1985.]

Senate Counters House Measure

In the second session of the 99th Congress, the Finance Committee met on a weekend retreat in West Virginia to consider their next step in the drafting process. As a result of strong Republican opposition to the House bill, the Committee rejected it as a starting point. After several more hearings were held by the Finance Committee [S. Hrg. 99-714, *Tax Reform Act of 1986*, Parts 1-5, January 29 through March 4, 1986], Chairman Packwood unveiled his own proposal for committee markup. [JCS-8-86, *Tax Reform Proposals in Connection With Committee on Finance Mark-up*, March 18, 1986.]

Although the Committee agreed to work from this document, it was not long before tax reform was again in danger. Members voted repeatedly to retain costly tax breaks, some more generous than current law. On April 18, 1986, when Finance was on the verge of another revenue losing vote, Chairman Packwood pulled his proposal from the table and adjourned his committee. At the time, the move was seen as the end of tax reform.

Sen. Packwood, however returned immediately to the drawing board. He and his staff opted to return to a decidedly fundamental approach. At an unusual press conference on April 24, 1986, the Chairman returned with a new package: to drop rates so radically (15%-25%) that members would be willing to forego many of their precious provisions.

Days later, the Committee began its most serious effort on this "new" concept. After days of marathon meetings behind closed doors, a final reform measure acceptable to most committee members began to take shape.

Shortly after midnight on May 7, 1986, the Committee approved the final package, with individual rates set at 15% and 27%, and a top rate of 33% for corporations. The final vote was 20-0 in favor of reporting the bill. [H.R. 3838, *Tax Reform Act of 1986*, as Reported in the Senate, Parts I and II. *Note:* Part I is simply the House bill struck out); S. Rep. No. 313, 99th Cong., 2d Sess., *Senate Finance Committee Report on H.R. 3838*, May 29, 1986. The Senate Report is reproduced in Volume I of this portfolio.] On June 24, 1986, with the Finance bill still intact, the Senate voted 97-3 on final passage after three weeks of fending off major amendments. However, there were close to fifty "minor" amendments adopted on the floor. [H.R. 3838, *Tax Reform Act of 1986* (as Amended by the Senate) June 24, 1986.]

Conference Action

On July 17, 1986, the Conference Committee, consisting of 11 Senators and 11 Representatives, began deliberations to reconcile the differences between their respective versions of tax reform. [JCS-15-86, *Comparison of Tax Reform Provisions of H.R. 3838 as Passed by the House and Senate*, July 15, 1986.] It was soon evident that the Conference Committee, as a whole, could not complete the task. The two sides split up into caucus meetings, exchanging numerous compromise proposals for several weeks. Frustrated by the lack of progress, members agreed to let

© 1987 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

their respective Chairmen negotiate one-on-one. Meetings between the two often lasted through the night, and after several set backs they emerged with a package presented to the full Conference only hours before a final vote was scheduled. The Conference Committee voted 17-5 on passage on August 16, 1986. [H.R. Rep. No. 841, 99th Cong., 2d Sess. (Vols. I & II), *Tax Reform Act of 1986, Conference Report to Accompany H.R. 3838*, September 18, 1986. The Conference Report is reproduced in Volume 1 of this portfolio.]

Tax Reform Enacted, Enrollment Corrections Fail

On September 25, 1986, the measure passed in the House by a vote of 292-136. The Senate voted 74-23 on September 27, 1986 to clear the bill. Neither side adopted floor amendments.

Before the President was to sign the measure, however, the House and Senate were left to agree on enrolling corrections to the tax bill, which are commonly offered in the form of a house concurrent resolution to correct technical mistakes made in the drafting process. Although the House managed to pass the measure (H. Con. Res. 395), several Senators attempted to use the legislation to restore substantive provisions. Both bodies adjourned *sine die* before a compromise could be agreed upon. As a result, although many corrections were made by the enrolling clerk, some of the more substantive errors will have to be addressed in the 100th Congress.

On October 22, 1986, President Reagan signed the tax bill into law. [P.L. 99-514, *Tax Reform Act of 1986*, October 22, 1986. The public law is reproduced in Volume I of this portfolio.]

Related Documents:

H.R. 1800, *Technical Corrections Act of 1985*, March 28, 1985.

S. 814, *Technical Corrections Act of 1985*, March 28, 1985.

H.R. 2110, *Technical Corrections to the Retirement Equity Act of 1984*, April 16, 1985.

Serial 99-29, *Technical Corrections Acts of 1985*, H.R. 1800 and H.R. 2110, Committee on Ways and Means, May 16, 1985.

WMCP-99-10, *Summary of Testimony Presented to the Committee on Ways and Means on the President's Tax Proposals*, September 26, 1985.

JCS-3-85, *Analysis of Proposals Related to Comprehensive Tax Reform*, February 26, 1985.

JCS-7-85, *Description of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814)*, April 14, 1985.

JCS-23-85, *Tax Reform Proposals: Tax Treatment of State and Local Government Bonds*, July 16, 1985.

JCS-25-85, *Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers*, July 18, 1985.

JCS-26-85, *Estimated Revenue Effects of the President's Tax Reform Proposal*, July 26, 1985.

JCS-32-85, *Tax Reform Proposals: Compliance and Tax Administration*, July 30, 1985.

JCS-33-85, *Tax Reform Proposals: Pensions and Deferred Compensation*, August 5, 1985.

JCS-34-85, *Tax Reform Proposals: Tax Shelters and Minimum Tax*, August 7, 1985.

JCS-35-85, *Tax Reform Proposals: Taxation and Capital Income*, August 8, 1985.

JCS-36-85, *Tax Reform Proposals: Rate Structure and Other Individual Income Tax Issues*, August 8, 1985.

JCS-38-85, *Tax Reform Proposals: Taxation of Financial Institutions*, September 12, 1985.

JCS-39-85, *Tax Reform Proposals: Accounting Issues*, September 13, 1985.

JCS-40-85, *Tax Reform Proposals: Corporate Taxation*, September 19, 1985.

JCS-41-85, *Tax Reform Proposals: Taxation of Insurance Products and Companies*, September 20, 1985.

JCS-42-85, *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans*, September 20, 1985.

S. Rept. 99-260, *Report on the Tax Reform Act of 1985 by the Senate Committee on Banking, Housing and Urban Affairs*, March 13, 1986.

© 1987 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

DETAILED ANALYSIS

Table of Contents

PAGE PAGE

CHAPTER 1 — INCLUSIONS IN GROSS INCOME

I. **Unemployment Compensation Benefits Included in Gross Income [Act §121]** 1:1
- A. Overview 1:1
- B. Detailed Analysis 1:1
- C. Effective Date 1:1

II. **Contributions in Aid of Construction Received by Utilities Includable in Gross Income [Act §824]** 1:1
- A. Overview 1:1
- B. Detailed Analysis 1:1
- C. Effective Date 1:2
- D. Exceptions 1:2

III. **Technical Corrections to Annuity Distribution Rules [Act §1826]** 1:2
- A. Overview 1:2
- B. Detailed Analysis 1:3
- C. Effective Date 1:3

IV. **Technical Corrections to the Alimony Rules [Act §1843]** 1:3
- A. Overview 1:3
- B. Detailed Analysis 1:3
- C. Effective Dates 1:4

CHAPTER 2 — EXCLUSIONS FROM GROSS INCOME

I. **Exclusion for Scholarships and Fellowships Restricted [Act §123]** 2:1
- A. Overview 2:1
- B. Present Law 2:1
- C. Changes Made by the Tax Reform Act of 1986 2:1
- D. Effective Date 2:2

II. **Exclusion for Prizes and Awards Restricted [Act §122]** 2:2
- A. Pre-TRA 1986 Law 2:2
- B. Changes Made By the Tax Reform Act of 1986 2:2
- C. Effective Date 2:3

III. **Repeal of Exclusion for Interest on Installment Payments of Life Insurance Proceeds [Act §1001]** 2:3

IV. **Exclusion For Structured Settlements Income Limited [Act §1002]** 2:4

V. **Capital Gains Exclusion Repealed [Act §§301, 406]** 2:4
- A. Pre-TRA Law 2:4
- B. Changes made by the Tax Reform Act of 1986 2:4
- C. Implications of Repeal of Long-Term Capital Gains Exclusion 2:4

VI. **Exclusion for Dividends Received By Individuals Repealed [Act §612]** 2:5

VII. **Exclusion for Certain Foster Care Payments Expanded [Act §1707]** 2:5

VIII. **Technical Corrections to the Tax Benefit Rule [Act §1812(a)]** 2:5

CHAPTER 3 — CHANGES TO THE CANCELLATION OF INDEBTEDNESS RULES

I. **Background** 3:1

II. **Overview** 3:2

III. **Detailed Analysis** 3:3
- A. Qualified Business Indebtedness Alternative Repealed 3:3
- B. Discharge of Trade or Business Debts of Solvent Farmers 3:3

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 4 — REVISION OF THE ACCELERATED COST RECOVERY SYSTEM AND EXPENSING

I. **Introduction** 4:1

A. Pre-ACRS Depreciation 4:1
B. Accelerated Cost Recovery System (ACRS) 4:1
1. Economic Recovery Tax Act of 1981 (ERTA) 4:1
2. Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Changes 4:2
3. 1984 Tax Reform Act Amendments 4:2
4. 1985 Legislation 4:2
C. Overview of Revised ACRS 4:2
D. Statutory Outline of Revised §168 4:4
E. Effective Dates 4:4
1. General 4:4
2. Transition Rules 4:5
a. Categories of Property 4:5
b. Class Life and Placement in Service Requirements 4:6
c. Rehabilitation Credit Transition Rule 4:7
d. Sales and Leasebacks 4:7
3. Pre-1987 Revised ACRS Election 4:8
a. General 4:8
b. Planning Considerations 4:8

II. **Detailed Analysis of the Revised ACRS** 4:9

A. Property Included 4:9
B. Excluded Property 4:9
1. Certain Depreciation Methods 4:9
2. Public Utility Property 4:10
3. Films, Video, Tapes, Sound Recordings 4:10
4. Anti-Churning Rules 4:10
a. Introduction 4:10
b. Application under Revised ACRS 4:11
C. Classification of Property 4:11
1. General 4:11
2. ADR Classification Rules 4:12
3. Revised ACRS Categories 4:13
a. General 4:13
b. Classification Based on ADR Life 4:13
c. Statutory Assignments 4:14
4. Real Property 4:15
D. Computation of Depreciation Allowance 4:16
1. General 4:16
2. Applicable Depreciation Method 4:16
3. Applicable Convention 4:16
4. Examples 4:17
a. 3-Year Property Examples 4:17
b. 5-Year Property Examples 4:17
c. 7-Year Examples 4:18
d. Real Property Examples 4:18
5. Use of Adjusted Basis 4:18
6. Short Taxable Years 4:18
E. Commencement and Termination of Depreciation 4:19
1. Placement in Service 4:19
2. Retirements; Dispositions 4:19
a. General 4:19
b. General Asset Accounts 4:20
F. Alternative Depreciation System 4:20
1. General 4:20
2. Categories of Property Included 4:20
a. Foreign Property 4:20
b. Tax-Exempt Use Property 4:21
c. Tax-Exempt Bond Financed Property 4:22
d. Executive Order Imported Property 4:22
3. Computation of Alternative Depreciation Deduction 4:23
4. Election of Alternative Depreciation System 4:23
G. Miscellaneous Rules 4:23
1. Improvements and Additions 4:23
2. Nontaxable Transfers 4:23
3. Reacquisitions 4:24
4. Leasehold Improvements 4:24
H. Changes in Expensing Provisions 4:24
I. Technical Corrections to Pre-1986 TRA ACRS 4:24

CHAPTER 5 — NEW RESTRICTIONS ON INTEREST DEDUCTION [Act §§511]

I. **Introduction** 5:1

A. General Rule 5:1
B. Definition of "Investment Interest" 5:1
C. The Tracing Problem 5:1
1. Prop. Regs. §57-2(b)(1)(iii) 5:1
2. Cases under §265 5:2
D. Persons Subject to §163(d) 5:2
E. Net Investment Income Factor 5:3
F. Special Rules 5:3

II. **Overview** 5:3

A. Investment Interest 5:3
1. Elimination of $10,000 Deductible Amount 5:3
2. Passive Loss Coordination 5:3
B. Personal Interest 5:3
C. Related Provisions 5:4

III. **Detailed Analysis** 5:4

A. Investment Interest Limitations 5:4
1. General Rule 5:4
2. "Investment Interest" Defined 5:4
3. "Property Held for Investment" Defined 5:4
4. "Net Investment Income" Defined 5:4
5. Persons To Whom Limitations Apply 5:5
6. The Tracing Problem 5:5
7. Effective Dates 5:5
B. Personal Interest 5:6
1. Qualified Residence Interest Defined 5:6
2. Secured Debt Requirement; Cooperatives 5:6
3. Interest on Deficiencies 5:7
4. Effective Date 5:7
C. Example 5:7
D. Miscellaneous Related Provisions 5:8
1. Amortizable Bond Premium Treated as Interest 5:8
2. Capitalization of Interest 5:8
3. Denial of Deduction for Interest on Loans From Certain Life Insurance Contacts 5:8
4. Alternative Minimum Tax Itemized Deductions 5:8

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 6 — DEDUCTION FOR MEALS, TRAVEL AND ENTERTAINMENT EXPENSES

I. **Overview** 6:1

II. **Pre-TRA Law** 6:1

III. **Changes made by the Tax Reform Act of 1986** 6:2

A. Meal expenses 6:2

B. Business entertainment 6:3

C. Travel Expenses for Business, Education and Charitable Activities 6:4

D. Travel Expenses for Attending Conventions 6:4

IV. **Effective Date** 6:4

CHAPTER 7 — MODIFICATION OF SPECIAL INDUSTRY DEDUCTIONS

I. **Limitation on Expensing of Soil and Water Conservation Expenditures** 7:1

A. Introduction 7:1

B. Detailed Analysis 7:1

1. New Conservation Plan Requirement 7:1

2. Deductions for Expenditures on Wetlands and Center Pivot Irrigation System Repealed 7:1

C. Effective Date 7:1

II. **Repeal of Land Clearing Expense Deduction** 7:1

III. **Limitation on Certain Prepaid Farming Expenses** 7:1

A. Introduction 7:1

B. Detailed Analysis 7:2

C. Effective Date 7:2

IV. **Deduction for Intangible Drilling Costs and Mineral Exploration and Development Costs Modified** 7:2

A. Introduction 7:2

B. Overview and Analysis 7:2

1. Intangible Drilling Costs 7:2

a. General Rule 7:2

b. Integrated Producers 7:2

c. Foreign IDCs 7:3

d. Exception to Foreign IDC Treatment 7:3

2. Mineral Exploration and Development Costs 7:3

a. General Rule 7:3

b. Corporation Rule Modified 7:3

c. Foreign Exploration and Development Costs 7:3

C. Effective Date 7:3

V. **Modification of Percentage Depletion Rules** 7:3

A. Introduction 7:3

B. Detailed Analysis 7:3

1. Limitations of Percentage Depletion for Oil and Gas 7:3

2. Modification of Corporate Preference Items Relating to Hard Minerals 7:4

3. Percentage Depletion Available for Royalty Income From Coal and Domestic Iron Ore 7:4

VI. **Repeal of Amortization of Railroad Grading and Tunnel Bores** 7:4

VII. **Deduction for Bus and Freight Forwarder Operating Authority** 7:4

CHAPTER 8 — MISCELLANEOUS BUSINESS DEDUCTIONS

I. **Modification of Hobby Loss Deduction** 8:1

A. Introduction 8:1

B. Overview 8:1

C. Detailed Analysis 8:1

1. Section 183(d) Presumption 8:1

2. Treatment Under 2% Floor 8:2

II. **Home Office Deductions** 8:2

A. Introduction 8:2

1. Rental Use 8:2

2. Amount of Deductions 8:3

B. Overview 8:3

C. Detailed Analysis 8:3

1. Requirements for Home Office Deductions 8:3

2. Limitations on Amount of Deduction 8:4

a. In General 8:4

b. Carryover of Unused Home Office Deductions 8:4

III. **Five-Year Amortization of Trademark and Trade Name Expenditures Repealed** 8:4

IV. **Expensing of Certain Architectural Barriers Expenditures Made Permanent** 8:4

V. **Deduction for Employee Achievement Awards Clarified [Act §§122(d)]** 8:4

VI. **Bad Debt Reserve (Other Than Financial Institutions)** 8:5

A. Background 8:5

1. In General 8:5

2. Computing the Addition to Reserve 8:5

3. Bad Debt Reserves for Guarantees of Dealers 8:5

B. Overview 8:6

C. Detailed Analysis 8:6

1. Bad Debt Reserve Repealed 8:6

2. Transitional Rules 8:6

3. Technical Amendments 8:7

4. Treasury Report Required 8:7

5. Planning Suggestions 8:7

VII. **Qualified Discount Coupons** 8:7

A. Background 8:7

B. Detailed Analysis and Effective Date 8:8

VIII. **Exceptions to Membership Organization Deduction Rules Expanded** 8:8

A. Introduction 8:8

B. Detailed Analysis 8:8

IX. **Certain Miscellaneous Business Costs Inventoried or Capitalized** 8:8

A. Costs other than Interest 8:8

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. Interest Capitalization 8:9
C. Sales and Transfer Tax Capitalization 8:9

X. Technical Amendments To Passenger Automobile Listed Property Rules And Gas Guzzler Tax 8:9

A. Introduction 8:9
1. Definition of Passenger Automobile 8:9
2. Listed Property 8:9
3. Gas Guzzler Tax 8:9
B. Overview 8:10
C. Detailed Analysis 8:10
1. Passenger Automobile Definition 8:10
2. Listed Property 8:10

XI. Demolition Loss Effective Date Clarification 8:11

A. Introduction 8:11
B. Effective Dates Clarified 8:11

CHAPTER 9 — MODIFICATION OF CERTAIN NON-BUSINESS DEDUCTIONS

I. Two-Earner Married Couple Deduction Repealed [Act §131] 9:1

II. Deduction for Adoption Expenses Repealed [Act §135] 9:1

III. Floor Under Medical Expense Deduction Increased [Act §133] 9:1

IV. Deduction for State and Local Sales Taxes Repealed [Act §134] 9:2

V. Impact of Certain Housing Allowances on Mortgage Interest and Property Tax Deductions [Act §144] 9:2

VI. Deduction for Non-Business Casualty Losses Clarified [Act §1004] 9:3

VII. Two Percent Floor Under Miscellaneous Itemized Deductions [Act §132] 9:3

A. Pre-1986 TRA Law 9:3
B. Changes made by the Tax Reform Act of 1986 9:3
1. In General 9:3
2. Estates and trusts 9:4
3. Special Rule for Actors and Performing Artists 9:5
4. Effective Date 9:5

VIII. Augmented Charitable Deduction for Donation of Scientific Equipment 9:5

A. Overview 9:5
B. Analysis 9:5
C. Effective Dates 9:6
D. Planning Suggestions 9:6

CHAPTER 10 — COMPUTATION OF TAXABLE INCOME AND TAX FOR NONCORPORATE TAXPAYERS

I. Computation of Taxable Income: Standard Deduction and Personal Exemption [Act §§102, 103] 10:1

A. Overview 10:1
B. Standard Deduction 10:2
1. Pre-1986 TRA Law 10:1
2. Changes Made by the Tax Reform Act of 1986 10:1
a. 1987 10:1
b. 1988 and Later Years 10:1
c. Additional Standard Deduction for the Elderly and Blind 10:2
d. Limitation on Standard Deduction for Certain Individuals 10:2
C. Personal Exemptions 10:2
1. Pre-1986 TRA Law 10:2
2. Changes Made by the Tax Reform Act of 1986 10:2
3. Phase Out of Personal Exemptions 10:3
D. Rules for Dependents 10:3
E. Adjustment for Inflation 10:3

II. Determination of Tax [Act §§101, 301, 302] 10:4

A. Pre-1986 TRA Law 10:4
B. Changes Made by the Tax Reform Act of 1986 10:4
1. Tax Rates — 1987 10:4
2. Tax Rates — 1988 and Later Years 10:4
3. Phase Out of the 15-Percent Bracket 10:5
4. Adjustment for Inflation 10:5

III. Income Averaging Repealed [Act §141] 10:6

IV. Special Rules for Unearned Income of Minors 10:6

A. Introduction 10:6
B. Overview 10:6
C. Detailed Analysis 10:6
D. Effective Dates 10:7
E. Planning Suggestions 10:7

V. Filing Requirements [Act §104] 10:7

CHAPTER 11 — AMENDMENTS AFFECTING THE INVESTMENT, ENERGY, AND REHABILITATION CREDITS

I. Background 11:1

II. Overview 11:1

III. Analysis of Credit Changes 11:2

A. Termination of Regular Investment Credit 11:2
1. General 11:2
2. Transition Property 11:2
a. General 11:2
b. Category Requirement 11:2
c. Placement in Service Requirement 11:4
d. Sales and Leasebacks; Section 48(d) Election 11:4
3. Credit Reduction 11:4
4. Full Basis Reduction 11:5

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

5. Steel Company and Farmer Carryback 11:5
B. Energy Investment Credit 11:6
1. Extension of Credit for Certain Property 11:6
2. Cutback and Basis Reduction for Certain Energy Property 11:6
C. Rehabilitation Credit 11:6
1. Reduced Percentages 11:6
2. Revised §48(g) Requirements 11:6
a. General 11:6
b. Qualified Rehabilitated Building; Substantial Rehabilitation 11:6
c. External, Internal Wall Test 11:6
d. Pre-1936 Requirement 11:7
e. Qualified Rehabilitation Expenditure 11:7
f. Certified Historic Rehabilitations 11:8
3. Effective Dates 11:8

CHAPTER 12 — NEW LOW-INCOME HOUSING CREDIT

I. Introduction 12:1
II. Detailed Analysis 12:1
A. Overview 12:1
B. Meeting the Minimum Set-Aside Requirement 12:1
C. Credit Amount 12:2
D. Qualified Basis 12:3
E. Additions to Qualified Basis 12:5
F. State Low-Income Housing Credit Authority Limitation 12:5
G. Recapture of the Credit and Penalty for Noncompliance 12:5
H. Transferability of the Credit and At-Risk Limitation 12:7
I. Coordination with the Passive Loss Rule 12:7
J. Transitional Relief from the Passive Loss Rule 12:7
K. Effective Date 12:8

CHAPTER 13 — EXTENSION AND MODIFICATION OF RESEARCH CREDIT RULES

I. Introduction 13:1
II. Overview 13:1
III. Detailed Analysis 13:2
A. Qualified Research 13:2
1. Technological Nature 13:2
2. Business Component 13:2
3. Process of Experimentation 13:2
4. Application of Tests 13:2
5. Activities for Which Credit Not Allowed 13:2
B. University Basic Research Credit 13:3
1. Qualifying Expenditures 13:3
2. Qualified Organizations 13:3
3. Rules for Computing the University Basic Research Credit 13:3
C. Interplay of Incremental Research Credit and University Basic Research Credit 13:3
D. Other Limits on the Credit 13:4

CHAPTER 14 — MISCELLANEOUS CREDITS

I. Extension and Modification of Targeted Jobs Credit 14:1
A. Introduction 14:1
B. Analysis 14:1
C. Effective Date 14:1
II. Alternative Minimum Tax Credit 14:1
A. Introduction 14:1
B. Overview of 1986 TRA Minimum Tax Credit 14:2
C. Analysis of Minimum Tax Credit 14:2
1. Computation of Credit 14:2
2. Application of Credit 14:4
3. Corporate Acquisitions 14:4
III. Extension of Orphan Drug Credit 14:4
A. Introduction 14:4
B. Extension of Orphan Drug Credit 14:4
IV. Increase in Earned Income Credit 14:4
A. Introduction 14:4
B. Analysis 14:5
1. Increase Amount of Credit 14:5
2. Inflation Adjustments 14:5
3. Employee Notification 14:5
V. Repeal of Political Contributions Tax Credit 14:5
A. Introduction 14:5
B. Analysis 14:5

CHAPTER 15 — NEW OR REVISED CREDIT LIMITATIONS

I. Introduction 15:1
A. Nonrefundable Personal Credits 15:1
B. Miscellaneous Credits 15:1
C. Business Credits 15:1
D. Alternative Minimum Tax 15:2
II. Outline of 1986 TRA Changes 15:2
III. Detailed Analysis 15:3
A. Consolidation of Credits into General Business Credit 15:3
1. Components of Credit 15:3
2. Tax Liability Limitation for 1986 15:3
3. Credit Carryover 15:3

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. Nonrecourse Financing Limit 15:4
1. General 15:4
2. Qualified Commercial Financing Exception 15:4
3. Partnerships and S Corporations 15:4
4. Subsequent Years; Lessees 15:4
C. Passive Activity Limit 15:5
1. Overview 15:5
2. Definition of Passive Activity 15:5
3. Taxpayers Subject to Passive Limits 15:5
4. Definition of Passive Loss and Credit 15:5
5. Exceptions 15:6
6. Suspended Passive Losses and Credits 15:6
7. Effective Dates and Phase-In Rules 15:7
D. Post-1986 Tax Liability Limitation: Alternative Minimum Tax 15:7
1. Nonrefundable Personal Credits 15:7
2. Miscellaneous Credits 15:8
3. General Business Credit 15:8

CHAPTER 16 — EXTENSION OF AT-RISK RULES TO REAL ESTATE

I. Introduction 16:1
II. Overview 16:1
III. Detailed Analysis 16:2
A. Qualified Nonrecourse Financing 16:2
B. Special Rule for Partnerships 16:2
C. Activity of Holding Real Property 16:2
IV. Implications 16:3

CHAPTER 17 — LIMITATIONS ON LOSSES AND CREDITS FROM PASSIVE ACTIVITIES

I. Overview 17:1
II. Detailed Analysis 17:2
A. Passive Activity 17:2
1. Definition of Activity 17:2
2. Material Participation 17:3
a. Involvement in Operations on a Regular, Continuous, and Substantial Basis 17:3
b. Closely Held C Corporations and Personal Service Corporations 17:4
c. Limited Partnerships 17:5
d. Treatment of Retired Individuals and Surviving Spouses Participating in Farming Activity 17:5
3. Rental Activity 17:6
a. Defining Rental Activity 17:6
b. Special Rule for Rental Real Estate Activities 17:7
B. Treatment of Losses and Credits 17:8
1. Losses 17:8
a. General Rules 17:8
b. Special Rule for Closely Held Corporations 17:9
c. Relation to Investment Interest Limitation 17:9
d. Relation to At-Risk Rules 17:9
e. Special Rule for Qualified Residence Interest 17:9
2. Credits 17:10
a. General Rules 17:10
b. Interaction with Other Credit Limitations 17:10
c. Relation to the $25,000 Real Estate Rental Allowance 17:10
3. Activity No Longer Treated As Passive 17:10
4. Change in Status of Closely Held C Corporation or Personal Service Corporation 17:10
5. Dispositions 17:11
a. General Rule 17:11
b. Disposition of Entire Interest 17:11
c. Fully Taxable Transaction 17:11
d. Related Party Transactions 17:11
e. Interaction with Capital Loss Limitation 17:11
f. Disposition by Death 17:12
g. Installment Sales 17:12
h. Gifts 17:12
i. Abandonment 17:12
j. Basis Adjustment for Credits 17:12
k. Changes in Nature of Activity 17:13
C. Treatment of Portfolio Income 17:13
1. General Rule 17:13
2. Loans Made to Pass-through Entities 17:13
3. Regulations re: Expenses Allocable to Portfolio Income 17:13
4. Regulatory Authority of Treasury in Defining Non-Passive Income 17:14
D. Working Interests in Oil and Gas Property 17:14
E. Effective Date and Transition Rules 17:15
1. Effective Date 17:15
2. Transition Rule 17:15
a. General 17:15
b. Pre-enactment Interests 17:15
c. Portion of Loss or Credit Eligible for Phase-in 17:16
d. Passive Loss and Credit Carryforwards During Phase-in Period 17:16
e. Application to $25,000 Allowance 17:16
f. Application of the Alternative Minimum Tax 17:16
g. Qualified Low Income Housing Projects 17:16
III. Implications 17:16
A. The Established Developer versus the New, Inexperienced Developer 17:16
B. The Developer Who Engages in Rental Activity and Sales Activity; Structuring Real Estate Ownership 17:17
C. Intentionally Failing the Material Participation Standard 17:18
D. Dispositions Where Suspended Losses From Activity Exceed Potential Gain 17:18
E. The Regulations Caveat 17:18

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 18 — MODIFICATION OF INSTALLMENT SALES RULES

I. **New Restrictions on Installment Sales** 18:1
A. Introduction 18:1
B. Overview 18:2
C. Detailed Analysis 18:2
1. Proportionate Disallowance Rule 18:2
a. Allocable Installment Indebtedness 18:3
b. Outstanding Debt 18:4
c. Special Rules Applicable to Affiliated Groups and other Related Parties 18:4
d. Alternative Minimum Tax 18:5
e. Timeshares and Residential Lots 18:5
f. Exception for Certain Sales by Manufacturers to Dealers 18:5
2. Revolving Credit Plans 18:6
3. Publicly-Traded Property 18:6
4. Effective Dates 18:6
a. Disproportionate Disallowance Rule 18:6
b. Revolving Credit Plans 18:7
c. Publicly-Traded Property 18:7

II. **The Impact of the General Utilities Repeal on Installment Sales Rules** 18:7
A. Introduction 18:7
B. Detailed Analysis 18:7

III. **Recognition of Section 751 Gain in an Installment Sale** 18:8

CHAPTER 19 — NEW CAPITALIZATION RULES FOR DEALERS AND PRODUCERS

I. Introduction 19:1
A. Pre-TRA 86 Law 19:1
1. Purchasers of Goods for Resale 19:1
2. Goods Manufactured for Inventory 19:1
3. Self-constructed Property and Non-Inventory Goods Manufactured for Sale 19:2
4. Construction Period Interest and Taxes 19:2
5. Sales Taxes 19:2
B. Reasons for Change 19:2

II. **Overview** 19:3
A. General Rule 19:3
B. Expenses other than Interest 19:3
C. Interest Capitalization 19:3
D. Sales and Transfer Tax Capitalization 19:3
E. Effective Date 19:3

III. **Detailed Analysis** 19:4
A. Uniform Capitalization Rules 19:4
1. Basic Changes 19:4
2. Exception for Certain Farm Property 19:5
a. General Rule 19:5
b. Preproductive Period 19:5
B. Election out of Uniform Capitalization Rules for Covered Farmers 19:6
1. Exception for Small Retailers and Wholesalers 19:6
2. Simplified Capitalization Method for Retailers and Wholesalers 19:6
3. Interest Capitalization 19:7
4. Property Purchase and Disposition Tax Capitalization 19:8
C. Effective Dates and Transition Rules 19:8

CHAPTER 20 — NEW LIMITATIONS ON COMPLETED CONTRACT METHOD

I. **Pre-1986 TRA Law** 20:1

II. **Overview** 20:2

III. **Detailed Analysis** 20:2
A. Percentage of Completion-Capitalized Cost ("40% PCM") Method 20:2
B. Exceptions to Use of 40% PCM Method 20:3
C. Percentage of Completion Look-Back Method 20:3
D. Interest Allocations 20:4
E. Effective Date 20:4

CHAPTER 21 — SIMPLIFICATION OF DOLLAR-VALUE LIFO METHOD FOR SMALL TAXPAYERS

I. **Introduction** 21:1
A. Background 21:1
B. Reasons for Change 21:1

II. **Overview** 21:2

III. **Detailed Analysis** 21:2
A. General Rule 21:2
1. Eligible Businesses 21:2
2. Making the Election 21:2
3. Computation of Simplified Dollar-Value LIFO Inventories 21:2
a. General Rule 21:3
b. Composition of Inventory Pools 21:3
c. Selection of Index 21:3
d. Rules Applicable to Year of Change 21:3
e. Rules Applicable When Taxpayer No Longer Eligible for Simplified Treatment 21:4
B. Effective Date and Transition Rule 21:5

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 22 — CASH METHOD LIMITED; ACCRUAL METHOD LIBERALIZED

I. **New Limitations on Use of Cash Method** 22:1

A. Introduction 22:1
1. Pre-TRA 1986 Law 22:1
2. Reasons for Change 22:1
B. Overview 22:1
C. Detailed Analysis 22:2
1. General Rule 22:2
2. Tax Shelters 22:2
3. Qualified Personal Service Corporations 22:3
4. Farming Business Exception 22:3
5. Small Business Exception 22:3
6. Effective Date and Transition Rules 22:4

II. **Full Accrual of Income Not Required for Certain Service Providers** 22:4

A. Introduction 22:4
1. Current Law 22:4
2. Reasons for Change 22:4
B. Overview 22:5
C. Detailed Analysis 22:5
1. General Rule 22:5
2. Effective Date 22:6

CHAPTER 23 — RESTRICTIONS ON ADOPTION OF A FISCAL YEAR BY PASS-THROUGH ENTITIES AND PERSONAL SERVICE CORPORATIONS

I. **Introduction** 23:1

A. Pre-1986 TRA Law 23:1
1. General Rules 23:1
2. Partnerships 23:1
3. S Corporations 23:2
4. Personal Service Corporations 23:2
B. Reasons for Change 23:2

II. **Overview** 23:2

III. **Detailed Analysis** 23:3

A. General Rule 23:3
B. Business Purpose Exception 23:3
C. Definition of Personal Service Corporation 23:4
D. Amendment of 52-53 Week Taxable Year Rules 23:4
E. Related Party Rules for Personal Service Corporations 23:4
F. Effective Date 23:4

CHAPTER 24 — MISCELLANEOUS ACCOUNTING METHOD AMENDMENTS

I. **New Income Accrual Requirements for Utilities** 24:1

A. Introduction 24:1
1. Background 24:1
2. Reasons for Change 24:1
B. Overview 24:1
C. Detailed Analysis 24:1
1. General Rule 24:1
2. Effective Date and Transition Rules 24:2

II. **Contributions in Aid of Utilities' Construction Included in Income of the Utility** 24:2

A. Introduction 24:2
1. Pre-1986 TRA Law 24:2
2. Reasons For Change 24:2
B. Detailed Analysis 24:2
1. General Rule 24:2
2. Effective Date 24:3

III. **Technical Corrections to the Tax Reform Act of 1984 Affecting Accounting Methods** 24:3

A. Clarification of Cash Basis Exception to Tax Shelter Rule — §461(i)(2) 24:3
1. Introduction 24:3
2. Detailed Analysis 24:3
B. Clarification of Application of §464 in §461(i)(2) 24:3
1. Introduction 24:3
2. Detailed Analysis 24:3
C. Treatment of Mining and Solid Waste Reclamation and Closing Costs 24:4
1. Introduction 24:4
2. Detailed Analysis 24:4
D. Treatment of Decommissioning of Nuclear Power Plants 24:4
1. Introduction 24:4
2. Detailed Analysis 24:4
E. Effective Date for Net Operating Loss Provisions 24:4
1. Pre-1986 TRA Law 24:4
2. Detailed Analysis 24:4
F. Clarification of Rules for Earlier Effective Date for Economic Performance Rules - §461(h) 24:4
1. Introduction 24:4
2. Detailed Analysis 24:4
G. Special Rules for Designated Settlement Funds 24:5
1. Introduction 24:5
2. Overview 24:5
3. Detailed Analysis 24:5
a. General Rule 24:5
b. Effective Date 24:6
H. Amendment of Treatment of Services 24:6
1. Introduction 24:6
2. Detailed Analysis 24:6

CHAPTER 25 — EXPANDED RELATED PARTY RULES

I. **Background** 25:1

II. **Overview and Effective Dates** 25:1

III. **Detailed Analysis** 25:1

A. Sales of Depreciable Property 25:1
B. Partnerships 25:2
C. Installment Sales 25:2
1. In General 25:2
2. Contingent Payments 25:2

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 26 — TAX STRADDLES

I. **Introduction** 26:1

II. **Amendment of the "Year-End Rule"** 26:1

III. **Amendments Relating to Foreign Currency Transactions** 26:2

IV. **Amendments to §108 of the 1984 TRA** 26:2

A. Section 108 of P.L.98-369 and the Miller Decision 26:2

B. 1986 TRA Amendments to §108(a): The London Options Cases 26:3

C. Other Amendments to §108 26:4

V. **Other Technical Corrections of the 1984 TRA Straddle Provisions** 26:5

A. Coordination of S Corporation Election and Election Under 1984 TRA §102(g) and (h) 26:5

B. Amendment to §263(g) 26:5

CHAPTER 27 — REVISED RULES FOR ALLOCATION OF PURCHASE PRICE IN ASSET ACQUISITIONS

I. **Overview** 27:1

II. **Detailed Analysis** 27:1

A. Residual Method 27:1

B. Applicable Asset Acquisitions 27:2

C. Information Reporting 27:2

D. Effective Date 27:2

CHAPTER 28 — MODIFICATIONS TO RECAPTURE PROVISIONS

I. **Changes Affecting Depreciation Recapture** 28:1

A. Background — Pre-1986 TRA Law 28:1

B. 1986 TRA Amendments to Section 1245 28:1

C. Effective Date 28:1

II. **Dispositions of Certain Wetlands and Croplands** 28:1

A. Analysis 28:1

1. Gain From Sale of Disposition 28:2
2. Loss Treated as Long-Term Capital Loss 28:2
3. Effective Date 28:2

III. **Disposition of Certain Oil, Geothermal, and Mineral Properties** 28:2

A. Introduction 28:2

B. Overview and Analysis 28:2

1. Depletion Costs Included 28:2
2. Disposition of Portion of Property 28:2
3. Effective Date 28:2

IV. **Disposition of Certain Plants and Animals for which Preproductive Expenses were Deducted** 28:2

A. Introduction 28:2

B. Overview 28:3

C. Analysis 28:3

1. Recapture of Preproductive Expenses which were Deducted 28:3
2. Effect of Election to Deduct Preproductive Period Expenses on Depreciation 28:3
3. Definitions 28:3
4. Effective Date 28:3

CHAPTER 29 — PROVISIONS RELATING TO MERCHANT MARINE CAPITAL CONSTRUCTION FUNDS

I. **Introduction** 29:1

II. **Overview** 29:1

III. **Detailed Analysis** 29:2

A. Coordination of Merchant Marine Act and Internal Revenue Code 29:2

B. Definition of "Qualified Withdrawals" 29:2

C. Tax Treatment of Nonqualified Withdrawals 29:2

D. Twenty Five Year Limit on Fund Deposits 29:2

E. Other Amendments 29:3

1. Exception to Definition of Tax Liability under §26(b) 29:3
2. Conformity with Merchant Marine Act of 1936 29:3

CHAPTER 30 — REVISION AND EXTENSION OF LIMITATIONS ON TAX-EXEMPT BONDS

I. **Overview** 30:1

II. **Detailed Analysis** 30:1

A. Section 103 30:1

B. Private Activity Bonds 30:2

1. Introduction 30:2
2. Trade or Business and Security Interest Tests 30:2
3. Management Contracts 30:2
4. Output Contracts 30:2
5. Unrelated Uses 30:3
6. Private Loan Bonds 30:3
7. Effective Date 30:3

C. Exempt Facility Bonds 30:4

1. Introduction 30:4
2. Use of Proceeds 30:4
3. Low and Moderate Income Housing 30:4
4. Additional Restrictions 30:6
5. Hazardous Waste 30:7
6. Effective Dates 30:7

D. Single Family Housing 30:7

1. Introduction 30:7
2. Use of Proceeds 30:7
3. Purchase Price Limit 30:8
4. Income Limitation 30:8
5. Qualified Veterans Mortgage Bonds 30:8

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

6. Effective Dates 30:8
E. Small Issue, Student Loan and Redevelopment Bonds 30:8
1. Small Issue Bonds 30:8
2. Student Loan Bonds 30:8
3. Qualified Redevelopment Bonds 30:8
4. Effective Dates 30:9
F. Qualified §501(c)(3) Bonds 30:9
1. Definition 30:9
2. Bond Limit 30:9
3. Effective Date 30:9
G. Volume Cap 30:9
1. Limitation 30:9
2. Veteran's Bonds 30:10
3. Effective Date 30:10
H. Other Requirements for PABs 30:10
1. Introduction 30:10
2. Bond Maturity Limit 30:10
3. Prohibition of Certain Uses 30:10
4. Public Approval Requirement 30:10
5. Limitation on Bond-Funded Issuance Costs 30:10
6. Effective Date 30:11
I. Arbitrage Restrictions 30:11
1. Introduction 30:11
2. Arbitrage Bond Definition 30:11
3. Higher Yielding Investments 30:11
4. Temporary Periods 30:11
5. 4R Funds 30:11
6. Computation of Bond Yield 30:11
7. Rebate Requirement 30:11
8. Nonpurpose Obligation Limit 30:12
9. Optional Penalty 30:12
10. Effective Dates 30:12
J. Registration and Other Requirements for all Tax Exempt Obligations 30:12
1. Registration Requirement 30:12
2. Prohibition on Federal Guarantee 30:12
3. Information Reporting 30:12
4. Advance Refundings 30:12
K. Special Rules 30:12
1. Volunteer Fire Department Bonds 30:12
2. Loss of Deductions for Change in Use 30:12
3. Effective Dates 30:12
L. Effective Date Provisions 30:13
1. General 30:13
2. Certain Construction and Binding Contracts 30:13
3. Current Refundings 30:13

III. Alternative Minimum Tax 30:13

CHAPTER 31 — AMENDMENTS RELATED TO TRANSACTIONS INVOLVING DEBT INSTRUMENTS

I. Bond Premium 31:1
A. Introduction 31:1
B. Statutory Provisions 31:2
C. Detailed Analysis 31:3

II. Short-Term Obligations 31:3
A. Background 31:3
B. Detailed Analysis 31:4

III. Market Discount Bonds 31:5
A. Background 31:5
B. Detailed Description of Amendments and Analysis 31:5

IV. Technical and Clerical Amendments 31:6
A. Transfers of Land Between Related Parties 31:6
B. "Clarification" of Application of Section 1273(b)(3)(B) 31:6
C. Clerical Amendments 31:7
D. Amendments Related to Section 44 of the Tax Reform Act of 1984 31:7

V. Amendments Relating to REMIC Interests 31:7

VI. Below Market Interest Loans 31:7

CHAPTER 32 — REVISED ALTERNATIVE MINIMUM TAX FOR NON-CORPORATE TAXPAYERS

I. Introduction 32:1
A. The Tax Reform Act of 1969 32:1
B. The Tax Reform Act of 1976 (P.L. 94-455) 32:2
C. Revenue Act of 1978 32:2
1. The Add-on Minimum Tax 32:2
2. Alternative Minimum Tax 32:3
D. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) 32:4
E. The Tax Reform Act of 1984 32:4
F. Alternative Minimum Tax Before the Tax Reform Act of 1986 32:4
G. The Tax Reform Act of 1986 32:5

II. Overview 32:5

III. Detailed Analysis 32:7
A. Introduction to Revised AMT 32:7
B. Computation of Net AMT Liability 32:7
1. Alternative Minimum Taxable Income (AMTI) 32:9
a. Items of Adjustment 32:10
b. Items of Tax Preference 32:30
c. Coordination With Certain Limitations 32:37
d. Optional 10-Year Write-Off of Certain Adjustments and Preferences 32:37
2. Tentative Minimum Tax 32:40
a. The Exemption Amount 32:40
b. Alternative Minimum Tax Foreign Tax Credit 32:40
3. Net AMT Liability 32:41
a. Regular Tax 32:41
C. Collateral Rules 32:43
1. Minimum Tax Credit 32:43
a. General 32:43
b. Operative Rules 32:43
2. Trusts and Estates 32:43
3. Apportionment of Differently Treated Items 32:43
4. Tax Benefit Rule 32:43
5. Short Taxable Year 32:44

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 33 — ALTERNATIVE MINIMUM TAX FOR CORPORATE TAXPAYERS

I. **Introduction** 33:1

A. The Tax Reform Act of 1969 33:1
B. The Tax Reform Act of 1976 33:2
C. Revenue Act of 1978 33:2
D. History of the Alternative Minimum Tax (AMT) 33:2
1. AMT Under the Revenue Act of 1978 33:2
2. AMT Under TEFRA 33:3
3. AMT Under the Tax Reform Act of 1984 33:4
4. Alternative Minimum Tax Before the Tax Reform Act of 1986 33:4
E. Corporate Add-On Minimum Tax Prior to the TRA 1986 33:5
1. Corporate Minimum Tax Base 33:5
a. Corporate Tax Preferences 33:5
b. Additional Preferences for Personal Holding Companies 33:6
2. Computation of Minimum Tax 33:7
3. Rules Pertaining to Foreign Source Deductions 33:7
4. Tax Benefit Rule 33:7
F. The Tax Reform Act of 1986 33:7

II. **Overview** 33:8

III. **Detailed Analysis** 33:10

A. Introduction to Corporate AMT 33:10
B. Computation of Net AMT Liability 33:11
1. Alternative Minimum Taxable Income (AMTI) 33:11
a. Items of Adjustment 33:13
b. Items of Tax Preference 33:35
c. Coordination With Certain Limitations 33:42
d. Optional 10-Year Write-Off of Certain Adjustments and Preferences 33:42
2. Tentative Minimum Tax 33:45
a. The Exemption Amount 33:45
b. Alternative Minimum Tax Foreign Tax Credit 33:45
c. Investment Tax Credit 33:46
3. Net AMT Liability 33:47
a. Regular Tax 33:47
C. Collateral Rules 33:48
1. Minimum Tax Credit 33:48
a. General 33:48
b. Operative Rules 33:48
2. Apportionment of Differently Treated Items 33:49
3. Tax Benefit Rule 33:49
4. Short Taxable Year 33:49
5. Possessions Corporations 33:49
6. Estimated Taxes 33:49

CHAPTER 34 — COMPUTATION OF CORPORATE TAXABLE INCOME AND AMOUNT OF TAX

I. **Inclusion of Contributions in Aid of Construction** 34:1

A. Background 34:1
B. Repeal of Exclusion for Contributions 34:1
C. Effective Date 34:1

II. **Changes in Dividends Received Deduction** 34:1

A. Background 34:1
B. TRA 1986 Amendments 34:2
1. Reduction in Dividends Received Deduction 34:2
2. Technical Corrections to 1984 Act Provisions 34:2
C. Effective Dates 34:2

III. **Nondeductibility of Stock Redemption Expenses** 34:2

A. Background 34:2
B. Disallowance of Deductions 34:3

IV. **Special Treatment for Capital Gains Repealed** 34:3

A. Background 34:3
B. Repeal of Corporate Capital Gains Rate Differential 34:3
C. Effective Date and Transitional Rules 34:3

V. Corporate Rate Reductions 34:3

A. Pre-TRA 1986 Rates 34:3
B. Rate Reduction 34:4
C. Effective Date and Transitional Rule 34:4

CHAPTER 35 — REVISION OF NOL AND CREDIT CARRYOVER RULES

I. **Introduction** 35:1

A. Summary of TRA Changes 35:1
B. Pre-TRA 1986 Law 35:1
1. Pre-TRA §382(a): Purchases 35:1
2. Pre-TRA §382(b): Reorganizations 35:1
3. Pre-TRA §269: Tax Avoidance Limitation 35:2
4. Lisbon Shops Doctrine 35:2
5. Consolidated Return Regulations 35:2
6. Tax Reform Act of 1976 35:2

II. **Overview** 35:3

A. Preliminary Legislative Proposals 35:3
B. Final Legislation 35:3
C. Effective Dates 35:3

III. **Detailed Analysis** 35:3

A. Ownership Change 35:3
1. Owner Shift Involving a 5% Shareholder 35:4
2. Equity Structure Shift 35:4
3. Multiple Transactions 35:5
B. Testing Period 35:5
C. Attribution and Other Rules Affecting Stock Ownership 35:5
D. Limitations on NOL Carryforwards 35:5
1. Continuity of Business Enterprise 35:5
2. Annual Limitation on Carryforwards 35:6
3. Special Rules Reducing Value of Old Loss Corporation 35:7
E. Built-In Losses and Gains 35:8
F. Bankruptcy Proceedings 35:8
G. Thrift Institutions 35:9
H. Other Carryforwards 35:9
I. Anti-abuse Rules 35:10
J. 1976 Amendments 35:10
K. Effective Dates 35:10

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 36 — NEW RULES GOVERNING CORPORATE LIQUIDATIONS: REPEAL OF GENERAL UTILITIES DOCTRINE

I. **Overview** 36:1

II. **Discussion** 36:1

A. Section 331 Liquidations 36:1
1. In General 36:1
2. Limits on Loss Recognition 36:1
3. Regulatory Authority 36:2
B. Section 337 Liquidations 36:2
C. Section 333 Liquidations 36:3
D. Section 332 Liquidations 36:3
1. In General 36:3
2. Section 336(e) Election 36:3
3. Mirror Subsidiary Transactions 36:3
E. Section 338 Transactions 36:4
F. Effective Dates and Transition Rules 36:5
1. In General 36:5
2. Pre-1989 Liquidations of Qualified Corporations 36:5

CHAPTER 37 — MODIFICATIONS TO CORPORATE DISTRIBUTION RULES

I. **Distributions of Appreciated Property by C Corporations** 37:1

A. Overview 37:1
B. Removal of Exceptions to Gain Recognition 37:1
C. Effective Date 37:2

II. **Reduction in Stock Basis for Nontaxed Portion of Extraordinary Dividends** 37:2

A. Background 37:2
B. Overview of Amendments 37:2
C. Detailed Analysis 37:2
1. Determination of Extraordinary Dividend 37:2
2. Holding Period 37:3
3. Qualifying Preferred Stock 37:3
4. Partial Liquidations and Non-Pro Rata Redemptions 37:4
a. Partial Liquidations 37:4
b. Non-Pro Rata Redemptions 37:4
5. Specific Exceptions and Additional Rules 37:4
6. Effective Dates 37:4

III. **Effect on Earnings and Profits of Appreciated Property Distributions** 37:5

A. Background 37:5
B. TRA 1986 Amendments 37:5
C. Effective Dates 37:5

IV. **Distribution of Partnership and Trust Interests** 37:6

A. Background 37:6
B. Limitation on Recognition of Gain 37:6
C. Effective Date 37:6

CHAPTER 38 — SPECIAL CORPORATE PROBLEMS

I. **Certain Built-in Gains of S Corporations Subject to C Corporation Tax** 38:1

A. Background 38:1
B. Tax on Built-In Gain of S Corporations 38:1
1. Recognized Built-in Gain 38:1
a. Dispositions 38:1
b. Treatment of Inventory 38:2
c. Property Acquired in Nonrecognition Transactions after Conversion 38:2
2. Net Unrealized Built-in Gain Limitation 38:2
3. Offsets Against Recognized Built-in Gain 38:3
4. Effect of Built-in Gain Tax 38:3
5. Comparison with Former Section 1374 38:3
C. Effective Date and Transition Rules 38:4
1. In General 38:4
2. Relief for Qualified Corporations 38:4
a. Qualified Corporations 38:4
b. Relief Available to Qualified C Corporations: The Analogue 38:4
c. Relief from Built-in Gain Tax 38:4
d. Relief from Recognition on Liquidation 38:6

II. **Amendments to Personal Holding Company Rules** 38:6

A. Background 38:6
B. Rate Reduction 38:7
C. New Exception For Computer Software Royalties 38:7
1. General Exclusion 38:7
2. Special Rules 38:7
D. Effective Dates 38:8

III. **Technical Amendments Relating to Affiliated Group Definition** 38:8

A. Background 38:8
1. Affiliated Group Definition 38:8
2. Includible Corporations - DISCs 38:8
B. Analysis of Technical Corrections Affecting Affiliated Groups 38:8
1. Overview 38:8
2. Excludable Stock Amendment 38:9
3. Grandfather Rule Clarifications 38:9
4. Election of Post-1984 Act Rules 38:9
5. Includible Corporations - Exclusion of Post-1984 DISCs 38:9
6. Sections 332, 337, and 338 Conforming Changes 38:9
C. Effective Dates 38:10

IV. **Technical Corrections to the Corporate Reorganization Rules** 38:10

A. Overview 38:10
B. Treatment of Transferor Corporations 38:10
C. Drop-Down of Assets Acquired in Reorganizations 38:11

V. **Technical Corrections to the Collapsible Corporation Rules** 38:11

A. Background 38:11
B. TRA Amendments 38:12
C. Effective Date 38:12

VI. **Technical Corrections to Redemption Rules** 38:12

A. Background 38:12
B. 1986 TRA Amendment 38:12
C. Effective Date 38:12

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 39 — COOPERATIVE HOUSING

I. **Background** 39:1
II. **Tax Reform Act Changes** 39:1
III. **Effective Date** 39:2

CHAPTER 40 — AMENDMENTS TO TAX TREATMENT OF REGULATED INVESTMENT COMPANIES

I. **Introduction** 40:1
II. **Overview — Statutory Changes** 40:1
III. **Detailed Analysis** 40:2
A. The 4% Excise Tax 40:2
B. Constructive Inclusion of Dividends 40:3
C. Tax Treatment of Series Funds 40:3
D. Hedging Gains 40:4
E. Expansion of RIC Income Definition 40:4
F. Treatment of RIC Operating Expenses 40:4
G. Preferential Dividends 40:5
H. Business Development Companies 40:5
I. The Disallowance of Losses on Certain Stock Sales 40:5
J. Stock Ownership Records 40:5
K. Notice and Third-Party Recordkeeper Changes 40:5

CHAPTER 41 — REAL ESTATE INVESTMENT TRUSTS

I. **Introduction** 41:1
A. Background 41:1
B. Overview 41:2
II. **The Tax Reform Act of 1986** 41:2
A. Changes to Basic Requirements 41:2
1. Calendar Year Accounting/Distributions 41:2
2. Initial Change in Accounting Period 41:2
3. Other Requirements 41:3
B. Penalty for Failure to Distribute
41:31. Generally 41:3
2. Deemed Distributions 41:3
3. Section 6697 Penalty 41:3
4. Sufficient Earnings and Profits 41:3
C. Asset and Income Requirements 41:3
1. Use of Subsidiaries 41:3
2. New Capital 41:3
D. Definition of Rents and Interest 41:4
1. Shared Appreciation Mortgages 41:4
2. Independent Contractor Rule 41:4
3. Rent or Income Based on Net Income 41:4
E. Distribution Requirements 41:4
F. Treatment of Capital Gains 41:5
1. Liberalization 41:5
2. Notice of Capital Gains Dividend 41:5
G. Prohibited Transactions 41:5
1. Safe Harbor Rules Liberalized 41:5
2. Effect of Net Loss 41:5
H. Effective Date 41:5

CHAPTER 42 — MORTGAGE BACKED SECURITIES: THE "REMIC"

I. **Background** 42:1
II. **Overview** 42:2
A. The REMIC 42:2
B. Regular Interests 42:3
1. In General 42:3
2. Taxation of Regular Interest Holders 42:3
C. Residual Interests 42:4
1. In General 42:4
2. REMIC Taxable Income (Loss) 42:4
a. Taxable Income of a REMIC 42:4
b. Net Loss of a REMIC 42:4
3. Taxation of Holders of Residual Interests 42:4
a. Special Rules for "Excess Accruals" 42:4
b. Treatment of Nonrecognized Gain/Loss 42:5
c. Application of the Wash Sale Rule 42:5
d. Procedural Rules 42:5
D. Prohibited Transactions; Liquidations 42:5
E. Miscellaneous Technical Amendments 42:6
1. Treatment for REIT Purposes 42:6
2. Treatment for Section 593 Purposes 42:6
3. Other Technical Amendments 42:6
F. Taxable Mortgage Pools 42:6
G. Effective Dates 42:6
III. **Detailed Analysis** 42:6
A. Basic REMIC Qualifications and Operating Rules 42:6
B. REMIC Interests 42:7
1. Regular Interests 42:8
a. In General 42:8
2. Residual Interests 42:10
a. In General 42:10
b. Pass-Through Rules 42:10
c. Other Rules Relating to Residual Interests 42:12
C. Prohibited Transactions 42:12
D. Terminations 42:13
E. Technical Amendments 42:14
F. Effective Dates: Taxable Mortgage Pools 42:14

CHAPTER 43 — TECHNICAL AMENDMENTS RELATING TO PARTNERSHIPS AND S CORPORATIONS

I. Retroactive Partnership Allocations 43:1

A. Background 43:1
B. TRA 1986 Amendment 43:1
C. Effective Date 43:1

II. Disguised Sales to Partnerships or Partners 43:1

A. Background 43:1
B. Extension to Property Exchanges 43:1
C. Effective Date 43:1

III. Distribution of Partnership and Trust Interests 43:1

IV. Like-Kind Exchanges 43:2

A. Background 43:2
B. TRA 1986 Amendment 43:2
C. Effective Date 43:2

V. Amendments to S Corporation Rules 43:2

A. Background 43:2
1. Qualified Subchapter S Trusts 43:2
2. Accumulated Adjustments Account 43:2
B. 1986 TRA Amendments 43:2
1. Qualified Subchapter S Trusts 43:2
2. Accumulated Adjustments Account 43:2
C. Effective Dates 43:2

CHAPTER 44 — AMENDMENTS RELATING TO COMPLIANCE REVISIONS

I. Tax Shelter Registration 44:1

A. Introduction 44:1
1. Tax Shelter Ratio Test 44:1
2. Tax Shelter Penalties 44:1
a. Penalty for Failure to Register a Tax Shelter 44:1
b. Failure to Furnish Tax Shelter Identification Number 44:2
c. Penalty for Failure to Maintain Lists of Tax Shelter Investors 44:2
B. Overview of 1986 TRA Changes 44:2
C. Detailed Analysis 44:2
1. Tax Shelter Registration Ratio 44:2
2. Tax Shelter Penalties 44:2
a. Failure to Register a Tax Shelter 44:2
b. Failure to Report Tax Shelter Identification Number 44:3
c. Failure to Maintain List of Tax Shelter Investors 44:3

II. Revised Penalty Provisions 44:3

A. Introduction 44:3
1. Penalties for Failure to File Information Returns or Statements and Furnish Copies 44:3
a. Failure to File Information Returns or Statements 44:3
b. Failure to Furnish Copies to Persons Entitled to Them 44:3
2. Penalty for Failure to Pay Tax 44:4
a. Failure to Pay Tax 44:4
b. Coordination of Failure to File Penalty and Failure to Pay Assessed Deficiency Penalty 44:4
3. Negligence and Fraud Penalties 44:4
a. Fraud Penalty 44:4
b. Negligence Penalty 44:4
c. Special Negligence Penalty 44:4
4. Penalty for Substantial Understatement of Income Tax Liability 44:5
B. Overview 44:5
C. Detailed Analysis 44:5
1. Penalties for Failure to File Information Returns or Statements 44:5
2. Increase in Penalty for Failure To Pay Tax 44:6
a. In General 44:6
b. Coordination of Penalty for Failure to File and Failure to Pay Assessed Deficiency 44:7
3. Negligence and Fraud Penalties 44:7
a. Fraud 44:7
b. Negligence Penalty 44:8
c. Special Negligence Penalty 44:8
d. Interaction of Fraud and Negligence Penalties 44:9
4. Penalty for Substantial Understatement of Liability 44:9
a. The Tax Reform Act of 1986 44:9
b. Interaction with the Omnibus Budget Reconciliation Act of 1986 44:9
5. Period of Limitations for Penalties 44:9

III. Information Reporting Requirements 44:9

A. Introduction — Pre-1986 TRA Law 44:9
1. Reporting by Brokers 44:10
2. Supplying Taxpayer Identification Numbers on Tax Returns 44:10
3. Information Reporting on Royalties 44:10
4. Information Reporting on the Receipt of Mortgage Interest 44:10
5. Information Reporting Requirements for Passthrough Entities 44:10
6. Mailing Requirements for Certain Payee Statements 44:10
7. Tax-Exempt Interest Reporting Requirements 44:10
B. Overview 44:10
C. Detailed Analysis 44:11
1. Information Reporting on Real Estate Transactions 44:11
2. Information Reporting on Federal Agency Contracts 44:11
3. Information Reporting on Royalties 44:12
4. Taxpayer Identification Numbers for Dependents 44:12
5. Tax-Exempt Interest Required to be Reported on All Returns 44:13
6. Mailing Requirements for Payee Statements 44:13
7. Reporting to Nominees of Passthrough Entities 44:13
8. Information Reporting by Cooperative Housing Corporation 44:14

IV. Modifications to the Interest Rules 44:14

A. Introduction — Pre-1986 TRA Law 44:14
1. Interest Rates on Underpayments and Overpayments of Tax 44:14
2. Interest on Accumulated Earnings Tax 44:14

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

3. Mandatory Imposition of Interest on Unpaid Tax 44:14
4. Compounding of Interest When Deficiency is Suspended 44:14
5. Imposition of Interest on "Tax-Motivated" Transactions 44:14
B. Overview of the 1986 TRA Changes 44:15
C. Detailed Analysis 44:15
1. Differential Interest Rates 44:15
2. Interest on Accumulated Earnings Tax 44:15
D. Authority to Abate Interest 44:16
E. Suspension of Compounding Where Interest on Deficiency is Suspended 44:16
F. Clarification of "Tax Motivated Transactions" for Interest Purposes 44:16

V. Fringe Benefit Plan Information Returns 44:17

A. Introduction — Pre-1986 TRA Law 44:17
B. Detailed Analysis 44:17

CHAPTER 45 — REVISED ESTIMATED TAX REQUIREMENTS

I. Introduction 45:1

II. Overview 45:1

III. Detailed Analysis 45:1

A. Current Liability Test 45:1
B. Estates and Trusts 45:2
C. Corporate Minimum Tax 45:2
D. Tax-Exempt Organizations 45:2
E. Waiver of Penalties for TRA 1984 and TRA 1986 Changes 45:2
F. Nonresident Aliens—TRA 1984 Correction 45:3

CHAPTER 46 — CHANGES AFFECTING ADMINISTRATIVE AND JUDICIAL PROCEDURES

I. Introduction 46:1

II. Analysis of Provisions 46:1

A. Suspension of Limitations if Third Party Records Not Produced 46:1
B. Authority to Rescind Notice of Deficiency 46:1
C. Penalty for Failure to Pursue Administrative Remedies 46:2
D. Jurisdiction Over Failure to File Penalty 46:3
E. Appeals from Tax Court Interlocutory Orders 46:3
F. Limits on Award of Court Costs and Fees 46:3
G. Tax Court Practice Fee 46:4
H. Modified Levy in Forfeiture Rules 46:4

CHAPTER 47 — INCOME TAXATION OF TRUSTS AND ESTATES

I. Introduction 47:1

II. Overview 47:1

III. Rate Schedules for Trusts and Estates 47:1

IV. Grantor Trust Rules 47:2

V. Taxable Years of Trusts 47:3

VI. Tax Payments 47:3

VII. Multiple Trusts 47:3

VIII. Distributions in Kind 47:3

IX. Deductibility of Trustee Fees and Other Administration Expenses 47:4

X. Alternative Minimum Tax 47:4

CHAPTER 48 — THE NEW GENERATION-SKIPPING TRANSFER TAX CONTAINED IN THE TAX REFORM ACT OF 1986, H.R. 3838

I. Pre-TRA Law 48:1

II. Legislative History of the TRA 1986 GSTT 48:2

III. The Department of the Treasury and the House Ways and Means Committee Cite Problems with the Pre-TRA GSTT 48:3

A. Sophisticated Mechanisms for Minimizing the Old GSTT 48:3

IV. Overview of the GSTT Contained in the Tax Reform Act of 1986 48:4

V. Detailed Explanation of the GSTT Contained in the Tax Reform Act of 1986 48:5

A. Definitions 48:5
1. Generation-Skipping Transfer 48:5
2. Trust/Trustee 48:5
3. Transferor 48:5
4. Interest 48:5
5. Skip Person/Non-Skip Person 48:6
6. Taxable Events 48:6
B. Taxation of Multiple Skips 48:7
C. Tax Amount Before Exemptions and Before Inclusion Ratio 48:7
D. Liability for GSTT 48:8
E. Exemptions 48:8
1. Predeceased Child Exclusion 48:8
2. Gift Tax Exclusions 48:8
3. $1,000,000 Exemption 48:9
a. Allocation of $1,000,000 Exemption 48:9
4. Direct Skip Exemptions 48:10
F. Determination of Amount of Tax at Flat Tax Rate 48:11
G. Inclusion Ratio 48:11

VI. Practical Issues Involved in Planning for the Use of Exemptions and Exclusions 48:12

A. Value of Total Assets and Necessity to Plan to be Able to Utilize the Exemptions 48:12

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. Inter Vivos Planning Using Exemptions and Exclusions 48:12
1. The Annual Exclusion from the Federal Gift Tax 48:12
2. $1,000,000 Exemptions 48:12
3. $2,000,000 Exemptions 48:13
C. Testamentary Use of Exemptions and Exclusions 48:14
1. Planning for the Use of the Predeceased Child Exclusion 48:14
2. $1,000,000 Exemptions 48:14
3. When Should the First Spouse Elect to be Treated as the Transferor Under Section 2652(a)(3) with Respect to QTIP? 48:15
4. $2,000,000 Exemptions 48:15
5. Interrelationship of $1,000,000 and $2,000,000 Exemptions 48:15
D. Planning If Assets Exceed the Exemptions 48:16

VII. Miscellaneous Provisions 48:17
A. Generation Assignment 48:17
B. Credit for State Taxes 48:17
C. Disclaimer 48:17
D. Income 48:17
E. Basis 48:18
F. Personal Liability of Trustee 48:18
G. Administration Provisions 48:18
H. Return Requirements 48:18
I. Extension of Time for Payment of GSTT on Direct Skips 48:18
J. Redemptions of Stock to Pay GSTT 48:18

VIII. Effective Dates 48:18

IX. Planning Considerations Involving the Effective Date Provisions 48:19

X. Planning Steps To Be Taken 48:19

CHAPTER 49 — MISCELLANEOUS ESTATE AND GIFT TAX PROVISIONS

I. Information Required for Valid Special Use Valuation Election 49:1

II. Estate and Gift Tax Deduction for Certain Conservation Easement Donations 49:2
A. Introduction 49:2
B. Analysis 49:2
C. Effective Date 49:3

CHAPTER 50 — MODIFICATION OF EXEMPT ORGANIZATION RULES

I. Certain Title-Holding Companies Granted Tax Exemption and Debt-Financed Income Relief 50:1
A. Overview 50:1
B. Analysis 50:1
1. Qualification 50:1
2. Application of Debt-Financed Income Rules 50:2
C. Effective Dates 50:2
D. Planning Suggestions 50:2

II. New Exceptions to the Unrelated Business Income Rules 50:3
A. Overview 50:3
B. Analysis 50:3
1. Rental of Mailing Lists 50:3
2. Distribution of Low-Cost Articles 50:4
3. Trade Show Income 50:4
C. Effective Date 50:4

III. Estimated Tax Requirements 50:4

IV. Definition of a Government Official for Private Foundation Purposes 50:5

CHAPTER 51 — EXECUTIVE COMPENSATION ISSUES

I. New Provisions Affecting Fringe Benefits 51:1
A. Introduction 51:1
B. Overview 51:1
C. Detailed Analysis 51:2
1. Changes in Statutory Fringe Benefits 51:2
a. Deductibility of Health Insurance Costs of Self-Employed Individuals 51:2
b. Educational Assistance Programs, Group Legal Plans, and Dependent Care Assistance Programs 51:2
2. Changes Affecting Campus Lodging 51:3
a. Pre- 1986 TRA Law 51:3
b. 1986 TRA Provisions 51:3
c. Effective Dates 51:3
4. Changes Affecting Military Fringe Benefits 51:3
a. Pre-1986 TRA Law 51:3
b. 1986 TRA Provisions 51:3
c. Effective Date 51:4
5. Changes Affecting the Employer's Deduction for Accrued Vacation Pay 51:4
a. Pre-1986 TRA Law 51:4
b. 1986 TRA Provision 51:4
c. Effective Date 51:4

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

6. Changes Affecting Full-Time Life Insurance Salespersons 51:4
a. Pre-1986 TRA Law 51:4
b. 1986 TRA Provision 51:4
c. Effective Date 51:4
7. Due Date for the Study of Welfare Benefit Plans 51:4
8. Technical Corrections 51:4
a. The Line-of-Business Requirement 51:4
b. Working-Condition Fringe Benefits 51:4
c. De Minimis Fringe Benefits 51:5
d. Definition of Dependent Children 51:5
e. Definition of Customer 51:5
f. Clarification of Employee Discounts 51:5
g. Excise Tax on Fringe Benefits 51:5
h. Cafeteria Plans 51:5
i. Telephone Service for Pre-Divestiture Retirees 51:5
j. Qualified Tuition Reduction 51:5

II. Stock Options (Section 321), Including Technical Corrections (Section 1855) 51:6

A. Introduction 51:6
B. Overview 51:6
C. Detailed Analysis 51:6
1. Amendments to Section 422A 51:6
a. Sequential Exercise Rule 51:6
b. Annual Limitation on Amount of ISOs 51:7
c. Effective Dates and Plan Amendments 51:7
2. Technical Corrections 51:8
3. Tax Rate Changes 51:8

III. Nonqualified Deferred Compensation and Section 457 51:9

A. Introduction 51:9
1. Section 457 51:9
2. Constructive Receipt 51:9
B. Overview 51:9
C. Detailed Analysis 51:9
1. Application to Tax-Exempt Employers 51:9
2. Distribution Requirements 51:10
3. Effective Date 51:10

IV. Golden Parachutes (Technical Corrections) 51:11

A. Introduction 51:11
B. Overview 51:12
C. Detailed Analysis 51:12
1. Exemption for Small Business Corporations 51:12
2. Reasonable Compensation 51:13
3. Exemption For Payments Under Qualified Plans 51:13
4. Treatment of Affiliated Groups 51:13
5. Limitation on Number of Individuals Treated As Highly Compensated 51:14
6. Excluded Amounts Not Taken Into Account In Determining Whether Threshold Amount Is Met 51:14
7. Limitation on Treatment of Payment Pursuant to Securities Law Violation as Parachute Payment 51:14
8. Clarification Concerning Independent Contractors 51:14
9. Clarification of Effective Date Provisions 51:14

V. Group Term Insurance Technical Corrections 51:14

A. Introduction 51:14
B. Overview 51:15

VI. Detailed Analysis 51:15

A. Determination of Includible Cost 51:15
B. Former Employees 51:15
C. Definition of Key Employee 51:15
D. Separate Treatment of Former Employees 51:15
E. Coordination with Section 83 51:15
F. Effective Date 51:15

CHAPTER 52 — NEW PROVISIONS FOR ESOPS

I. Introduction 52:1

II. Overview 52:2

III. Detailed Analysis 52:2

A. Estate Tax Exclusion 52:2
B. Deductibility of Dividends 52:3
C. Partial Interest Exclusion 52:3
D. Asset Reversions 52:4
E. Tax Credit ESOPs 52:4
F. Distributions 52:4
G. Put Options 52:5
H. Diversification Requirements 52:5
I. Independent Appraisal 52:6
J. Prohibited Allocations 52:6
K. Special Rules 52:6
L. Miscellaneous Technical Corrections 52:6
1. Section 1042 Nonrecognition Rules 52:7
2. Section 2210 Estate Tax Liability Changes 52:7

CHAPTER 53 — WELFARE PLANS

I. Introduction 53:1

A. Pre-1986 TRA Law 53:1
1. Health Plans 53:1
2. Group-Term Life Insurance Plans 53:1
3. Group Legal Services Plans 53:1
4. Educational Assistance Programs 53:2
5. Dependent Care Assistance Programs 53:2
6. Welfare Benefit Funds 53:2
7. Cafeteria Plans 53:2
B. Reasons for Change 53:2

II. Overview 53:2

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

III. **Detailed Analysis** 53:3

A. Plan Formality, Permanence and Exclusivity Requirements 53:3
B. Reporting Requirements 53:4
C. Nondiscrimination Rules 53:4
1. Mandatory Versus Elective Application of Section 89 53:4
2. Eligibility Tests 53:4
a. 50 Percent Test 53:4
b. 90/50 Percent Test 53:5
c. General Nondiscrimination 53:5
3. Benefits Test 53:5
a. In General 53:5
b. Plan Safe Harbor 53:6
c. Special Dependent Care Assistance Test 53:6
4. Alternative Test 53:6
5. Amount Includible in Income 53:6
D. Special Health Plan Rules 53:7
1. Separate Testing 53:7
2. Sworn Statements 53:7
3. Part-Time Employees 53:8
4. Coordination of Benefits 53:8
E. Special Group-Term Life Insurance Rule 53:8
F. Highly Compensated Employees 53:8
G. Excludable Employees 53:9
H. Separate Lines of Business 53:10
I. Definitions and Special Rules 53:11
1. Time for Testing 53:11
2. Special Rules for Dispositions and Acquisitions 53:12
3. Separate Plans 53:12
4. Valuation 53:12
5. Former Employees 53:12
6. Self-employed Persons 53:12
7. Cafeteria Plans 53:13
8. Welfare Benefit Funds 53:13
J. Effective Dates 53:13

IV. **Technical Corrections to Welfare Benefit Plan Provisions** 53:14

A. Reserves for Discriminatory Post-Retirement Benefits 53:14
B. Actuarial Certification 53:14
C. Aggregation of Funds 53:14
D. Definition of Fund 53:14
E. Tax on Unrelated Business Income 53:14
F. Tax on Disqualified Benefits 53:15
G. Effective Dates 53:15
H. Fully Vested Vacation Pay Plans 53:15

V. **Continuation Health Coverage Under the Consolidated Omnibus Budget Reconciliation Act (Technical Corrections) of 1985** 53:15

A. Introduction 53:15
1. Scope of Continued Coverage 53:15
2. Length of Continued Coverage 53:15
3. Type of Coverage 53:16
4. Premium Requirements 53:16
5. Notice of and Election for Continued Coverage 53:16
6. Exceptions 53:16
7. Consequences of Failure to Comply With the COBRA Requirements 53:16
8. Effective Date 53:16
B. Overview 53:17
C. Detailed Analysis 53:17
1. Modifications of Plan Coverage 53:17
2. Maximum Required Period of Continuation Coverage 53:17
3. Grace Period for Payment of Premiums 53:17
4. Termination of Continuation Coverage Upon Coverage By Another Group Health Plan Rather Than Upon Reemployment Or Remarriage 53:17
5. Clarification Relating To Election By Beneficiaries 53:17
6. Notice Requirements 53:17
7. Nonresident Aliens 53:18
8. ERISA Definition of "Group Health Plan" 53:18
9. Aggregation Rules for Employers Under ERISA 53:18
10. Effective Date 53:18

CHAPTER 54 — NEW OR REVISED QUALIFICATION REQUIREMENTS FOR QUALIFIED PLANS

I. **Qualified Plan Coverage Rules and Related Provisions** 54:1

A. Introduction 54:1
B. Overview 54:1
C. Detailed Analysis 54:1
1. Highly Compensated Employees 54:1
a. Definition 54:1
b. Effective Date 54:2
2. Includible Compensation 54:2
3. Coverage Tests 54:3
a. Percentage Test 54:3
b. Ratio Test 54:3
c. Average Benefits Test 54:3
d. Aggregation and Comparability 54:4
e. Excludable Employees 54:4
f. Special Rules for Dispositions or Acquisitions 54:5
g. Former Employees 54:5
h. Line of Business Exception 54:5
i. Special ESOP Rule 54:6
j. Sanctions 54:6
k. Effective Dates 54:6
4. Minimum Participation Requirement 54:7
a. Separate Benefit Structures 54:7
b. Excludable Employees 54:7
c. Exemptions from the Minimum Participation Rules 54:8
d. Exemption from Reversion Tax 54:8
e. Effective Date 54:8
5. Minimum Vesting Requirements 54:8
a. Vesting Schedules 54:8
b. Effective Date 54:9
6. Integrated Plans 54:9
a. Defined Contribution Plans 54:9
b. Defined Benefit Excess Plans 54:9
c. Defined Benefit Offset Plans 54:10
d. Multiple Integrated Plans 54:11
e. Effective Dates 54:11

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

7. Nondiscrimination Rules 54:11
a. General 54:11
b. Integrated Defined Benefit Plans 54:11
c. Single Plan Treatment 54:11
d. Effective Dates 54:11

II. Contribution and Benefit Limitations 54:11

A. Introduction 54:11
B. Overview 54:12
C. Detailed Analysis 54:13
1. Defined Contribution Plans 54:13
a. Dollar Limitations 54:13
b. After-Tax Contributions 54:13
c. Technical Correction to Tax Reform Act of 1984 54:14
2. Defined Benefit Plans 54:14
a. Dollar Limitations 54:14
b. Actuarial Adjustments for Retirement Before Social Security Retirement Age 54:14
c. Reduction for Service Less Than Ten Years 54:14
d. Specialized Dollar Limit Rules 54:15
3. Qualified Cost-of-Living Arrangements 54:16
4. Limit on Annual Compensation 54:17
5. Code Section 415 Limits May Be Incorporated in Plans by Reference 54:17
6. Special Catch-Up Election for Tax-Sheltered Annuity Plans 54:17
7. Planning Tip 54:17
8. General Effective Dates 54:18
a. In General 54:18
b. Transition Rules 54:18

III. 401(k) and Thrift Plans 54:18

A. Introduction 54:18
1. Cash or Deferred Arrangements 54:18
2. After-Tax Employee Contributions 54:19
B. Overview 54:19
1. Limitations on Elective Contributions 54:19
2. Antidiscrimination Rules Under Section 401(k) 54:19
3. Antidiscrimination Rules for Thrift Plans 54:20
4. Excess Contributions 54:20
5. Other Rules 54:20
6. Effective Date 54:21
C. Detailed Analysis 54:21
1. Limits on Elective Deferrals 54:21
a. Dollar Limits 54:21
b. Treatment of Excess Contributions 54:21
c. Effective Dates 54:22
2. Antidiscrimination Requirements for Section 401(k) Plans 54:23
a. Definition of Highly-Compensated 54:23
b. Compensation Definition 54:23
c. ADP Limits 54:23
d. Treatment of Excess Contributions 54:24
3. Antidiscrimination Rules for Employer Matching Contributions and Employee Contributions 54:25
a. Nondiscrimination Tests 54:25
b. Treatment of Excess Aggregate Contributions 54:25
c. Relationship to Section 401(k) Plan 54:26
d. Effective Date 54:26
4. Other Changes 54:27
a. Withdrawal Restrictions 54:27
b. Service 54:27
c. Exempt Organizations 54:27
d. Benefits Not Contingent on Election to Defer 54:28
5. Effective Date 54:28

IV. Other Qualification Rules 54:28

A. Introduction 54:28
1. Interest Rate Assumptions 54:28
2. Profits Required 54:29
3. Benefit Forfeitures 54:29
4. Bona Fide Collective Bargaining Agreements 54:29
5. Ratable Accrual of Benefits for Top-Heavy Purposes 54:29
6. REA Exception 54:29
B. Overview 54:30
1. Interest Rate Assumptions 54:30
2. Elimination of Profits Requirement 54:30
3. Benefit Forfeitures 54:30
4. Bona Fide Collective Bargaining Agreements 54:30
5. Ratable Accrual for Top-Heavy Purposes 54:30
6. Exception From REA Provisions 54:30
C. Detailed Analysis 54:30
1. Interest Rate Assumptions 54:30
2. Profits Not Required 54:31
3. Benefit Forfeitures 54:31
4. Bona Fide Collective Bargaining Agreements 54:31
5. Ratable Accrual of Benefits for Top-Heavy Purposes 54:31
6. REA Special Exception 54:32

V. Miscellaneous 54:32

A. Penalty for Overstatement of Pension Liabilities 54:32
1. Pre-1986 TRA Law 54:32
2. 1986 TRA Provisions 54:32
B. Treatment of Certain Fishermen as Self-Employed 54:32
1. Pre-1986 TRA Law 54:32
2. New Provision 54:32
C. Tax Treatment of Federal Thrift Savings Fund 54:32
1. Pre-1986 TRA Law 54:32
2. 1986 TRA Provision 54:33

VI. Leased Employees 54:33

A. Introduction 54:33
B. Overview 54:33
C. Detailed Analysis 54:33
1. Safe Harbor Provisions 54:33
a. Plan Requirements 54:33
b. Twenty Percent of Nonhighly Compensated Work Force 54:34
2. Applicability of Employee Leasing Requirements 54:34
3. Years of Service 54:34
4. Record keeping Requirement 54:34
5. Effective Date 54:34

VII. Qualification Procedures 54:34

A. Introduction 54:34
1. Pre-Act Law 54:34

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

2. Reasons for Change 54:35
B. Overview 54:35
C. Detailed Analysis 54:35
1. Time for Making Plan Amendments 54:35
2. Model Amendment 54:36
3. Required Date for Regulations 54:36
4. Master and Prototype Section 401(k) Plans 54:36

VIII. Taxation of Employer Contributions and Tax on Nondeductible Contributions 54:36

A. Introduction 54:36
B. Overview 54:37
C. Detailed Analysis 54:38
1. Repeal of Limit Carry Forward 54:38
2. Deduction Limits Applicable to Combination Defined Benefit and Money Purchase Plans 54:38
3. Nondeductible Contributions Subject to 10% Excise Tax 54:38
4. Effective Dates 54:39

CHAPTER 55 — INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAS) AND SIMPLIFIED EMPLOYEE PLANS (SEPS)

I. New Provisions Affecting IRAs 55:1

A. Introduction 55:1
1. Pre-1986 TRA Law 55:1
2. Reasons for Change 55:1
B. Overview 55:2
1. Provisions 55:2
2. Effective Dates 55:2
C. Detailed Analysis 55:2
1. Eligibility 55:2
a. Active Participant Status 55:2
b. Nonparticipant Status 55:3
2. Amount of Contribution 55:3
a. Nonparticipants 55:3
b. Active Participants 55:3
3. Distributions 55:4
a. General 55:4
b. Mandatory Distributions 55:4
c. Premature Withdrawals 55:4
4. Miscellaneous Provisions 55:4
D. Planning Suggestions 55:4

II. Simplified Employee Pension Plans 55:5

A. Introduction 55:5
B. Overview 55:5
C. Detailed Analysis 55:5
1. Salary Reduction Arrangements 55:5
2. Taxation of SEPs 55:6
3. Participation Requirements 55:6
4. Integration 55:6
5. Effective Date 55:6

III. Section 501(c)(18) Plans 55:6

A. Introduction 55:6
B. Overview 55:7
C. Detailed Analysis 55:7

CHAPTER 56 — ELECTIVE DEFERRAL LIMITATIONS AND NONDISCRIMINATION RULES FOR TAX-SHELTERED ANNUITIES

I. Introduction 56:1

II. Overview 56:1

A. Contribution Limitations 56:1
B. Coverage and Nondiscrimination Rules 56:2

III. Detailed Analysis 56:2

A. Limits on Elective Deferrals 56:2
B. Nondiscrimination Requirements for Tax-Sheltered Annuities 56:3
1. Elective Deferrals 56:3
2. Non-Elective Deferrals 56:3
a. In General 56:3
b. Integration 56:4
c. Aggregation of Plans 56:4
d. Excludable Employees 56:4
e. Aggregation Based on Line of Business 56:4
C. Constructive Receipt 56:4

CHAPTER 57 — TREATMENT OF DISTRIBUTIONS

I. Minimum Distribution Requirements 57:1

A. Introduction 57:1
1. Pre-Act Before-Death Distribution Rules 57:1
2. After-Death Distributions 57:1
3. Rationale for Change 57:2
B. Overview 57:2
C. Detailed Analysis 57:2
1. Uniform Required Beginning Date 57:2
2. Excise Tax for Failure to Make Minimum Required Distributions 57:2
3. Effective Date 57:3

II. Taxation of Distributions 57:3

A. Introduction 57:3
B. Overview 57:4
C. Detailed Analysis 57:4
1. Elimination of 10-Year Forward Averaging 57:4

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

2. Pre-1974 Capital Gains Treatment 57:5
3. Basis Recovery Rules 57:5
a. Pre-Annuity Starting Date Distributions 57:5
b. Elimination of Three-Year Basis Recovery Rule 57:6
c. Post-Annuity Starting Date Distributions 57:6
d. IRA Basis Rules 57:6
4. Special Treatment for Rollover Distributions 57:7
a. Partial Rollovers 57:7
b. Extension of Rollover Period for Certain Frozen Deposits 57:7
5. Repeal of Constructive Receipt for Qualified Annuities 57:7
6. Net Unrealized Appreciation 57:7
7. Effective Dates 57:7
D. Technical Corrections 57:8
1. Retirement Equity Act of 1984 57:8
a. Lump Sum Distributions 57:8
b. Rollovers 57:8
c. Qualified Pre-retirement Survivor Annuity 57:8
d. Plans to Which Survivor Pay-Out Rules Apply: Transferee Plans 57:9
e. Qualified Joint and Survivor Annuity 57:9
f. Waiver of Survivor Benefits 57:9
g. Spousal Consent Election Period and Notice Requirements 57:9
h. Annuity Starting Date Definition 57:10
i. Qualified Domestic Relations Orders 57:10
j. Procedures for Disputed Payments under QDROs 57:10
k. Cash-Out Rules ($3,500) 57:10
l. Transition Rules 57:11
2. Tax Reform Act of 1984 57:11
a. Rollovers 57:11
b. Distributions from Employee-Funded Plans 57:11
c. Estate Taxation 57:11

III. Penalty Tax on Early Distributions From Qualified Plans 57:12

A. Introduction 57:12
1. Withdrawal Restrictions 57:12
2. Additional Income Tax On Early Distributions 57:12
B. Overview 57:12
1. Withdrawal Restrictions With Regard to Elective Deferrals 57:12
2. Additional Tax on Early Distributions 57:12
C. Detailed Analysis 57:13
1. Withdrawal Restrictions 57:13
2. Additional Income Tax on Early Withdrawals 57:13
a. General Rule 57:13
b. Exceptions 57:13
c. Other Early Distributions - Non-Qualified Plans 57:15
d. Effective Dates 57:15
D. Technical Corrections to Tax Reform Act of 1984 57:15
1. Penalty Tax 57:15
2. Minimum Distributions 57:15

IV. Loans 57:15

A. Introduction 57:15
B. Overview 57:16
C. Detailed Analysis 57:16
1. Fifty-Thousand Dollar Limitation 57:16
2. Amortization of Loan in Level Payments 57:16
3. Home Loan Exception 57:17
4. Deductibility of Interest 57:17
5. Effective Date 57:17

V. Penalty Tax on Excess Distributions 57:17

A. Introduction 57:17
B. Overview 57:17
C. Detailed Analysis 57:18
1. Income Tax on Excess Distributions 57:18
a. General Limits 57:18
b. "Grandfather" Limits 57:19
2. Additional Estate Tax on Excess Distributions 57:19
3. Effective Dates 57:20
D. Technical Corrections 57:20
1. Retirement Equity Act 57:20
a. Qualified Domestic Relations Orders 57:20
2. Tax Act of 1984 57:20
a. Rollovers by Surviving Spouses 57:20

VI. Excise Tax on Reversion of Qualified Plan Assets to Employer 57:20

A. Introduction 57:20
B. Overview 57:21
C. Detailed Analysis 57:21
1. In General 57:21
2. Exception for ESOPS 57:21
3. Effective Date 57:22

VII. Deferred Annuities Available Only to Natural Persons 57:22

A. Introduction 57:22
B. Overview 57:23
C. Detailed Analysis 57:23

CHAPTER 58 — AMENDMENTS TO EMPLOYMENT TAX RULES

I. Introduction 58:1

A. Employment Taxes - General Rules 58:1
1. Federal Insurance Contributions Act (FICA) 58:1
2. Federal Unemployment Tax Act (FUTA) 58:1
3. Withholding Taxes 58:1
4. Self-Employment Contributions Act (SECA) 58:1
5. Classifying Workers 58:1
B. Treatment of Certain Technical Personnel 58:2
C. Exemption for Certain Clergy 58:2
D. Exception for Churches and Church Organizations 58:2

E. Application of the FUTA Tax to Indian Tribal Governments 58:2

II. Overview 58:2

III. Effective Dates 58:2

IV. Detailed Analysis 58:3

A. Treatment of Certain Technical Personnel 58:3
B. Exemption for Certain Clergy 58:3
C. Exception for Churches and Church Organizations 58:3
D. Application of the Federal Unemployment Compensation Tax to Indian Tribal Governments 58:4

CHAPTER 59 — FOREIGN TAX CREDIT: CHANGES AND REFINEMENTS

I. Introduction 59:1

II. The Extension of Separate Limitations Categories 59:3

A. Background and Legislative History 59:3
B. Overview 59:4
1. The New Separate Limitation Categories 59:4
2. Passive Income 59:4
a. Export Financing Income 59:5
b. High-Taxed Income 59:5
c. Foreign Oil and Gas Extraction Income 59:5
3. High Withholding Tax Interest 59:5
4. Financial Services Income 59:6
5. Shipping Income 59:6
6. Dividends From Noncontrolled §902 Corporations 59:6
7. Related Person 59:7
8. Transitional Rule 59:7
9. The Look-Through Rules 59:7
a. Introduction 59:7
b. Dividends, Interest, Rents and Royalties; Subpart F Inclusions 59:7
10. Definitions; Regulations Authorized 59:10
11. The "Source Rule" 59:10
12. Effective Dates 59:11
C. Detailed Analysis 59:11
1. The Expansion of the Separate Limitations Categories 59:11
a. Passive Income: Exceptions 59:11
b. High Withholding Tax Interest 59:12
c. Financial Services Income 59:14
2. The Look-Through Rules 59:14
a. Conformity With Subpart F Rules 59:14
b. Dividends 59:15
c. Interest, Rents and Royalties 59:15
d. The Source or "Netting" Rule 59:16
e. Miscellaneous Amendments 59:16

III. Amendments to the Deemed Paid Credit 59:16

A. Background and Legislative History 59:16
B. Overview 59:17
1. Pooling of Post-1986 Earnings and Profits and Foreign Taxes 59:17
2. Special Rule for Post-1986 Acquisitions 59:18
3. Accounting Periods 59:18
4. Distributions From Pre-1987 Earnings 59:18
5. Conforming the §960 Credit 59:18
6. Regulatory Authority 59:18
7. Effective Date 59:18
C. Detailed Analysis 59:18
1. General Observations 59:18
2. Regulations: The Separate Limitations Problem 59:19
3. Repeal of the Subpart F "Chain Deficit Rule" 59:19

IV. Clarification of the Treatment of Foreign Losses 59:20

A. Background and Legislative History 59:20
B. Overview 59:20
1. Foreign Loss Allocation and Recharacterization Rules 59:20
2. U.S. Loss Allocation Rule 59:20
3. Definitions 59:20
4. Effective Date 59:20
C. Detailed Analysis 59:20

V. Other Foreign Tax Credit Related Provisions 59:22

A. Codification of Regs. §901-2(e)(3): Taxes Used as Subsidies 59:22
1. Statutory Provisions 59:22
2. Committee Report Comments 59:22
B. Limitations on Carrybacks to Pre-1987 Years 59:22

Addendum — Notice 87-6 59:23

CHAPTER 60 — TAX TREATMENT OF FOREIGN CURRENCY — §§985-989

I. Overview 60:1

A. Introduction 60:1
B. Summary 60:1
1. Functional Currency 60:1
2. Foreign Currency Transactions 60:2
3. Foreign Currency Translation 60:2
4. Miscellaneous Provisions 60:3
C. Effective Date 60:3

II. Detailed Analysis 60:3

A. Functional Currency 60:3
1. Background 60:3
2. General Rules 60:4
3. Definition of a QBU 60:4

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

4. Economic Environment of a QBU 60:5
a. U.S. Dollar Economic Environment 60:5
b. Facts and Circumstances Test 60:6
c. Volume of Local Currency Activities 60:7
5. Books and Records Requirement 60:7
6. Election to Use U.S. Dollar 60:8
7. Exception to General Rule that Transactions be Accounted for in Functional Currency Terms 60:9
8. Functional Currency Treated as an Accounting Method 60:9
B. Foreign Currency Transactions 60:9
1. Background 60:9
2. Transactions Covered Under the Act 60:10
3. General Consequences Associated with Section 988 Transactions 60:10
a. Timing and Amount of Exchange Gain or Loss 60:10
b. Character of Section 988 Transaction Exchange Gain or Loss 60:12
c. Interest Income or Interest Expense Characterization 60:13
d. Source of Section 988 Transactions Exchange Gain or Loss 60:14
4. Consequences of Selected 988 Transactions 60:15
a. Currency Transactions 60:15
b. Accounts Payable and Accounts Receivable 60:16
c. Foreign Currency Debt Instruments 60:16
d. Foreign Currency Loans 60:19
e. Forward, Futures and Options Contracts 60:22
f. Currency Swaps 60:22
g. Hedging Transactions 60:25
5. Effective Date 60:26
C. Foreign Currency Translation 60:26
1. Background 60:26
a. Determination of U.S. Dollar Taxable Income or Loss 60:26
b. Determination of Allowable Foreign Tax Credits 60:27
2. Profit or Loss of Foreign Branch 60:27
a. Prior Law 60:27
b. Overview of Changes 60:28
c. Reasons for Changes 60:28
d. Detailed Analysis 60:19
3. Translation of Earnings and Profits and Distributions of a Foreign Corporation 60:30
a. Prior Law 60:30
b. Overview of Changes 60:32
c. Reasons for Changes 60:32
d. Detailed Analysis 60:32
4. Foreign Tax Credit 60:33
a. Prior Law 60:33
b. Overview of Changes 60:33
c. Reasons for Changes 60:34
d. Detailed Analysis 60:34
Addendum — Notice 87-11 60:36

CHAPTER 61 — MODIFICATIONS TO THE SOURCE OF INCOME AND DEDUCTIONS RULES

I. Introduction 61:1

II. Treasury Department Recommendations 61:1

A. Introduction 61:1
B. Source Rules Relating to Sales Income 61:2
C. Income Derived from Sales of Intangible Property 61:2
D. 80-20 Corporation Rules Relating to Interest and Dividends 61:2
E. Allocation of Interest Expense 61:3

III. The President's Tax Proposals 61:3

A. Introduction 61:3
B. Source Rules Relating to Sales Income 61:4
C. Income Derived from Sales of Intangible Property 61:5
D. 80-20 Corporation Rules Relating to Interest and Dividends 61:5
E. Transportation Income 61:5
F. Allocation of Interest Expense 61:6
G. Basis for Proposals 61:6

IV. Tax Reform Act of 1985: Proposals by the House to Modify the Source Rules 61:6

A. Introduction 61:6
B. Determination of Source of Income Derived from Sales of Personal Property 61:6
1. Income from the Sale of Personal Property: In General 61:6
2. Income from the Sale of Inventory Property 61:7
3. Income from the Sale of Depreciable Personal Property 61:7
4. Income from the Sale of Intangible Property 61:8
C. Limitations, Dividends and Interest Paid by 80-20 Companies 61:8
D. Source Rule for Transportation Income 61:9
E. Source of Income Rule for Space and Ocean Activities 61:9
F. Allocation and Apportionment of Expenses to Foreign Source Income 61:9
G. Modification to Rules on Allocation of Research and Experimental Expenditures 61:11

V. The Senate Amendment to H.R. 3838: Modifications to the Source Rules 61:11

A. Source of Income from Sales of Personal Property 61:11
1. In General 61:11
2. Special Rules for United States Persons 61:11
3. Income Derived from the Sale of Depreciable Personal Property 61:12
4. Income Derived from the Sale of Intangible Property 61:12
5. Income Derived from the Sale of Personal Property by Foreign Persons 61:12

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. 80-20 Dividend and Interest Rules 61:12
C. Income from Transportation Activities 61:13
1. Source of Transportation Income 61:13
2. Gross-Basis Tax 61:13
3. Reciprocal Exemption 61:14
D. Source of Income from Space and Certain Ocean Activities 61:14
E. Allocation and Apportionment of Expenses to Foreign Source Income 61:15
1. Interest Expenses 61:15
2. Expenses Other Than Interest 61:16

VI. Tax Reform Act of 1986: Modifications to the Source of Income and Deduction Rules 61:16

A. Introduction 61:16

B. Determination of Source of Income Relating to Sales of Personal Property 61:17
1. Introduction 61:17
2. General Rules 61:17
3. Sales of Inventory 61:17
4. Depreciable Personal Property Exception 61:17
a. In General 61:17
b. Special Rule for Gain in Excess of Depreciation 61:18
c. United States Depreciation Adjustments 61:18
5. Special Rules for Intangible Property 61:18
6. Sales of Personal Property Through Offices or Fixed Places of Business 61:18
a. Sales by United States Residents 61:18
b. Sales of Personal Property by Nonresidents 61:18
7. Sales of Stock in Foreign Affiliated Companies 61:19
8. Losses from Sales of Personal Property 61:19
9. Effective Dates 61:19
10. Treasury Department Study on Sales of Inventory Property 61:19
C. Special Rules for Transportation Income 61:19
1. Introduction 61:19
2. Source of Transportation Income 61:19
3. Four Percent Gross Basis Tax 61:19
4. Reciprocal Tax Exemption 61:20
5. Effective Dates 61:20
D. Special Source Rules for Space and Certain Ocean Activities and International Communications Income 61:20
1. Space and Certain Ocean Activities 61:20
2. International Communications Income 61:21
3. Effective Dates 61:21
E. Limitations on the Special Treatment of 80-20 Corporations 61:21
1. Introduction 61:21
2. Modifications to the 80-20 Rules 61:21
F. Allocation and Apportionment of Interest and Other Expenses to Foreign Source Income 61:23
1. Introduction 61:23
2. New Rules for Allocating Interest and Other Expenses 61:23
3. Treasury Regulations 61:23
4. Effective Dates and Transitional Rules 61:24
a. General Three Year Rule 61:24
b. Special 4 and 5-Year Transition Rules for Consolidated Pool Calculations 61:24
G. Allocation and Apportionment of Research and Experimental Expenditures 61:24

CHAPTER 62 — NEW BRANCH PROFITS TAX

I. Introduction 62:1

II. Present Law 62:1

III. Detailed Analysis 62:1

A. Tax Base — The Dividend Equivalent Amount 62:1
B. Branch Tax — The Branch Level Interest Tax 62:3
C. Relationship with Tax Treaties 62:3
D. Coordination with the Second Level Withholding Tax 62:4
E. Regulations 62:5
F. Effective Date 62:5

IV. Consequences of the Branch Profits Tax 62:5

A. Interaction and Conflict with Treaties 62:5
B. Technical Problems with the Branch Profits Tax 62:6

CHAPTER 63 — THE SCOPE OF SUBPART F RULES BROADENED

I. Pre-TRA 1986 Law 63:1

II. Overview 63:1

A. Gain From the Sale of Property That Does Not Generate Income 63:1
B. Gains From Commodity Transactions 63:2
C. Foreign Currency Gains 63:2
D. Income Equivalent to Interest 63:2
E. Dividends, Interest and Gains of Banks and Insurance Companies 63:2
F. Related Person Exceptions 63:3
G. Insurance Income 63:3
H. Captive Insurance Company Income 63:3
I. Foreign Base Company Shipping Income 63:5
J. Foreign Corporation Not Used to Reduce Taxes 63:5
K. Definition of Related Person 63:5
L. Repeal of the Chain Deficit Rule and Modification of the Accumulated Deficit Rule 63:5

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

M. Effective Date - TRA 1986 §1221 63:8
N. New Definition of Controlled Foreign Corporations [TRA 1986 §1222(a)] 63:8
O. Definition of Foreign Personal Holding Company [TRA §1222(b)] 63:8
P. Effective Dates — TRA §1222(c) 63:8
Q. Subpart F De Minimis Rule [TRA §1223] 63:8
R. Effective Date — TRA §1223(c) 63:8
S. Repeal of Special Treatment for Possessions Corporations [TRA §1224] 63:9
T. Effective Dates — TRA §1224(b) 63:9

CHAPTER 64 — NEW RULES GOVERNING THE TREATMENT OF CERTAIN PASSIVE FOREIGN INVESTMENT COMPANIES [ACT §1235]

I. Introduction 64:1
A. Foreign Personal Holding Companies 64:1
B. Controlled Foreign Corporations 64:1
1. Current Inclusion of E&P in Income of U.S. Shareholders 64:1
2. Ordinary Income Treatment of Gain on Sale or Exchange of CFC Stock 64:2
C. Foreign Investment Companies 64:2
II. Overview 64:3
III. Detailed Analysis 64:3
A. Definition of PFIC 64:3
1. Passive Income Defined 64:3
2. Look-Through Rule 64:4
3. Start-Up Year Corporations and Corporations Changing Businesses 64:4
B. Taxation of Shareholders of PFICs 64:4
1. General 64:4
a. Excess Distributions 64:5
b. Dispositions 64:6
C. Taxation of Qualified Electing Funds 64:7
1. Previously Taxed Amounts 64:7
2. Manner of Making Election 64:7
3. Shareholder Level Election to Extend Time for Payment of Tax on Undistributed Earnings 64:7
D. Attribution Rules 64:8
1. Attribution From Corporations 64:8
a. Attribution From 50% Owned Corporations 64:8
b. Attribution From Less Than 50% Owned Corporations 64:8
2. Attribution From Partnerships, Trusts and Estates 64:8
3. Reattribution 64:8
4. Separate Interests Treated as Separate Corporations 64:9
E. Coordination With Other Code Sections 64:9
F. Miscellaneous 64:9
G. Regulations Needed 64:9
H. Effective Date 64:10

CHAPTER 65 — NEW RULES GOVERNING THE TREATMENT OF DUAL RESIDENT COMPANIES [ACT §1249]

I. Introduction 65:1
II. Overview 65:1
III. Detailed Analysis 65:2
A. General 65:2
B. Exception 65:2
C. Treaty Considerations 65:2
D. Effective Date 65:3

CHAPTER 66 — MODIFICATIONS TO §936 [ACT §1231]

I. Introduction 66:1
A. Background 66:1
B. Section 936 66:1
1. Election 66:1
2. Eligibility for §936 Credit 66:1
3. Amount of the Credit 66:2
4. Definition of "Possession of the United States" 66:2
C. Intercompany Transfer Pricing and Treatment of Intangibles 66:2
1. Section 482 66:2
2. Code §367(d) 66:3
3. Code §936(h) 66:4
a. Significant Business Presence Test 66:4
b. Election Out 66:4
c. Cost Sharing Method 66:4
d. Profit Split Method 66:5
II. Overview 66:6
A. Modifications to Cost Sharing Payment 66:6
B. Profit Split Method Modifications 66:6
C. Receipt of Income Within the United States 66:6
D. QPSII Redefined 66:6
E. Modification to Gross Income Test 66:6
III. Detailed Analysis 66:7
A. Modifications to Cost Sharing Payments 66:7
B. Profit Split Method Modifications 66:8
C. Receipt of Income Within the United States 66:8
D. QPSII Redefined 66:8
E. Modification to Gross Income Test 66:9
IV. Effective Dates 66:9

CHAPTER 67 — DEDUCTIONS FOR DIVIDENDS RECEIVED FROM FOREIGN CORPORATIONS

I. Introduction 67:1
II. Analysis of Revised Section 245(a) 67:2
A. Qualified 10% Owned Foreign Corporation 67:2
B. U.S. Source Portion 67:2
C. Coordination with Foreign Tax Credit Rules 67:3
D. Effective Date 67:3

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 68 — INTERCOMPANY TRANSFER PRICING: INTANGIBLES; IMPORTS

I. **Background and Legislative History** 68:1
A. Background - Transfer Pricing Theories under §482 68:1
1. The Unitary Approach 68:1
2. The Separate Entity Approach 68:2
3. IRS Practice 68:2
B. Transfers of Intangible Property: Prior Law 68:2
1. Section 482 68:2
2. Sections 367 and 936 68:3
C. The House Bill 68:4

II. **Overview** 68:4

III. **Detailed Analysis of Provisions Concerning Transfers of Intangibles** 68:5
A. General Observations 68:5
B. What Does "Commensurate With the Income Attributable to the Intangible" Mean? 68:6
C. Cost Sharing 68:6
D. Double Taxation Problems 68:7
E. Conclusions 68:7

IV. **Detailed Analysis of Valuation of Imports Provisions** 68:8

CHAPTER 69 — FOREIGN COMPLIANCE PROVISIONS

I. **Information Returns With Respect to Certain Foreign-Owned Corporations** 69:1
A. Introduction 69:1
B. Overview 69:1
C. Detailed Analysis 69:2

II. **Information Returns Required of U.S. Citizens and Residents Abroad** 69:2
A. Introduction 69:2
B. Overview 69:2
C. Detailed Analysis 69:2

III. **Withholding on Certain Deferred Payments Outside the United States** 69:3
A. Introduction 69:3
B. Overview 69:3
C. Detailed Analysis 69:3

IV. **Withholding Tax on Amounts Paid by Partnerships to Foreign Partners** 69:3
A. Introduction 69:3
B. Overview 69:4
C. Detailed Analysis 69:4
1. In General 69:4
2. Limitation 69:4

CHAPTER 70 — CHANGES AFFECTING U.S. POSSESSIONS

I. **Treatment of Interest on Obligations of the United States Received by Banks in Guam** 70:1
A. Introduction 70:1
B. Overview 70:1
C. Detailed Analysis 70:1

II. **Authority of Guam, American Samoa and Northern Mariana Islands to Enact Revenue Laws** 70:1
A. Introduction 70:1
B. Overview 70:2
C. Detailed Analysis 70:2
D. Effective Date 70:3

III. **Exclusion of Possessions Source Income From the Gross Income of Certain Individuals** 70:3
A. Introduction 70:3
B. Overview 70:3
C. Detailed Analysis 70:3
D. Effective Date 70:4

IV. **Treatment of Corporations Organized in Guam, American Samoa, or the Northern Mariana Islands**
A. Introduction 70:4
1. Definition of "U.S. Person" for Subpart F Purposes 70:4
2. Exemption from Withholding Tax 70:4
B. Overview 70:4
C. Detailed Analysis 70:5

V. **Coordination of U.S. and Virgin Islands Income Taxes** 70:5
A. Introduction 70:5
B. Overview 70:5
C. Detailed Analysis 70:5
1. Treatment of U.S. Citizens or Residents with Virgin Islands-Source Income 70:6
2. Treatment of Virgin Islands Residents 70:6
3. Authority to Impose Local Income Taxes 70:6

VI. **Virgin Islands Corporations Allowed Possessions Tax Credit** 70:6
A. Introduction 70:6
B. Overview 70:6
C. Detailed Analysis 70:7
1. Repeal of the Inhabitants Rule 70:7
2. Possession Tax Credit 70:7
3. Reduction of Virgin Islands Tax Liability 70:7
D. Conforming Amendments 70:7
E. Effective Dates 70:7

VII. **Amendments to Section 7654** 70:8
A. Introduction 70:8
B. Overview 70:8
C. Detailed Analysis 70:8

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

CHAPTER 71 MISCELLANEOUS FOREIGN PROVISIONS

I. **Foreign Personal Holding Stock Ownership Test Modified [Act §1222(b)]** 71:1
A. Background—Pre-1986 TRA Law 71:1
B. Detailed Analysis of 1986 TRA Provisions 71:1
C. Effective Date 71:2

II. **Foreign Personal Holding Company Taxable Income Includes Effectively Connected Gain or Loss Only [Act §1225(b)]** 71:2
A. Introduction 71:2
B. Detailed Analysis 71:2
C. Effective Date 71:2

III. **Accumulated Taxable Income of Foreign Corporations Effectively Connected Gain Only Taken Into Account [Act §1225(a)]** 71:2
A. Background—Pre-TRA Law 71:2
B. Detailed Analysis of 1986 TRA Provisions 71:3
C. Effective Date 71:3

IV. **Section 911 Exclusion Modified** 71:3
A. Introduction 71:3
B. Overview 71:3
C. Detailed Analysis 71:3
1. Foreign Earned Income Exclusion Amount 71:3
2. Disallowance for Violation of Foreign Travel Restrictions 71:3

V. **Income of Foreign Governments** 71:4
A. Introduction 71:4
B. Overview 71:4
C. Detailed Analysis 71:5
1. Investment Income 71:5
2. Commercial Income 71:5
3. Controlled Commercial Entity 71:5
4. International Organizations 71:5

VI. **Effectively Connected Income Will Retain Its Character in Subsequent Years** 71:5
A. Pre-1986 TRA Law 71:5
B. Overview 71:6
C. Detailed Analysis 71:6

VII. **Tax Free Exchanges of Tax Avoidance Expatriates** 71:6
A. Introduction 71:6
B. Overview 71:6
C. Detailed Analysis 71:7

VIII. **Transfer Prices for Imports** 71:7

IX. **Treatment of Certain Persons in Panama [Act §1232]** 71:7
A. Background 71:7
B. Detailed Analysis 71:8
C. Effective Dates 71:8

X. **Study of U.S. Reinsurance Industry** 71:8
A. Introduction 71:8
B. Overview 71:9
C. Detailed Analysis 71:9

CHAPTER 72 TECHNICAL CORRECTIONS TO THE FOREIGN PROVISIONS

I. **Maintaining the Source of Income [Act §1810(a)]** 72:1
A. Introduction 72:1
B. The Tax Reform Act of 1984 72:1
C. Technical Corrections 72:1

II. **Maintaining the Character of Income [Act §1810(b)]** 72:2
A. Introduction 72:2
B. Tax Reform Act of 1984 72:2
C. Technical Corrections 72:3
D. Effective Dates 72:3

III. **Related Party Factoring Income [Act §1810(c)]** 72:3
A. Introduction 72:3
B. Tax Reform Act of 1984 72:4
C. Technical Corrections 72:4
1. Investment in U.S. Property 72:4
2. Current Inclusion of Factoring Income 72:4
3. Separate Limitation Treatment 72:4

IV. **Repeal of Withholding Tax on Portfolio Interest [Act §1810(d)]** 72:4
A. Introduction 72:4
B. Tax Reform Act of 1984 72:4
C. Technical Corrections 72:5

V. **OID Income and Deduction for Foreign Persons [Act §1810(e)]** 72:5
A. Introduction 72:5
B. Tax Reform Act of 1984 72:5
C. Technical Corrections 72:6

VI. **Amendments to FIRPTA [Act §1810(f)]** 72:6
A. Introduction 72:6
B. Tax Reform Act of 1984 72:6
C. Technical Corrections 72:7
1. Election To Be Treated As A Domestic Corporation 72:7
2. Withholding Exemptions for Transfers of Stock in Certain Domestic Corporations 72:7
3. Foreign Corporate Transferors — Notice Giving and Withholding Responsibilities of Agents 72:7
4. Treatment of Certain Domestic Partnerships, Trusts and Estates 72:7
5. Distributions by U.S. RPHCs to Foreign Shareholders 72:8
6. Taxable Distributions by Partnerships, Trustees and Executors 72:8
7. Miscellaneous 72:8

VII. **Outbound Transfers Under §367 [Act §1810(g)]** 72:8
A. Introduction 72:8
B. Tax Reform Act of 1984 72:8
C. Technical Corrections 72:8

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

VIII. Amendments to FPHC Rules [Act §1810(h)] 72:9

A. Introduction 72:9
B. Tax Reform Act of 1984 72:9
1. Same Country Dividend and Interest Rule 72:9
2. Stock Held Through a Foreign Entity 72:9
C. Technical Corrections 72:9
1. Same Country Dividend and Interest Exception 72:9
2. Stock Held Through Foreign Entity 72:10

IX. Amendments to Code §1248(i) [Act §1810(i)] 72:10

A. Introduction 72:10
B. Tax Reform Act of 1984 72:10
C. Technical Corrections 72:10

X. Stapled Stock Provisions of §269B Amended [Act §1810(j)] 72:11

A. Introduction 72:10
B. Tax Reform Act of 1984 72:11
C. Technical Corrections 72:11

XI. Foreign Base Company Services Income Provisions Clarified [Act §1810(k) 72:11

A. Introduction 72:11
B. Tax Reform Act of 1984 72:11
C. Technical Corrections 72:12

XII. Amendments to the Definition of a Resident Alien [Act §1810(l)] 72:12

A. Introduction 72:12
B. Tax Reform Act of 1984 72:12
C. Technical Corrections 72:13

XIII. Technical Amendments to FSC Provisions [Act §1876] 72:13

A. Introduction 72:13
B. Foreign Sales Corporations 72:14
1. Clarification of Corporate Preference Reductions 72:14
2. Dividends Received Deduction for Certain Distributions Out of Earnings and Profits 72:14
3. Exchange of Information Requirements 72:14
4. Maintenance of Principal Bank Accounts 72:15
5. Taxation by United States Possessions 72:15
C. Changes in DISC Treatment 72:15
1. Corporate Preference Reduction 72:15
2. Interest Charge on Former DISC 72:15
3. Changes in Treatment of Old DISCs 72:15
4. Effective Date of Tax Year Conformity Requirement 72:16

XIV. Estimated Tax for Nonresident Aliens [Act §1841] 72:16

A. Introduction 72:16
B. Tax Reform Act of 1984 72:16
C. Technical Corrections 72:16

CHAPTER 73 MISCELLANEOUS AMENDMENTS PERTAINING TO EXCISE TAXES

I. Introduction—Pre-TRA Law 73:1

A. Gasoline and Gasohol Tax 73:1
1. Manufacturer's Excise Tax on Gasoline 73:1
a. Imposition of Tax 73:1
b. Exemptions 73:1
2. Manufacturer's Excise Tax on Gasohol 73:1
B. Diesel Fuel Tax 73:1
1. Imposition of Tax 73:1
2. Exemption From Tax 73:2
3. Light Weight Diesel Vehicle Credit 73:2
C. Retail Excise Tax On Piggyback Trailers or Semitrailers 73:2

II. Overview of 1986 TRA Changes 73:2

III. Detailed Analysis 73:3

A. Gasoline Excise Tax Revised 73:3
1. Imposition of Tax 73:3
2. Exemption 73:4
B. Changes in Gasohol Tax 73:4
C. Alternate Method of Collecting Diesel Fuel Tax Created 73:4
1. Imposition of Tax 73:4
2. Changes in Exemptions 74:5
C. Change in Recapture of Piggyback Excise Tax 73:5
D. Other Changes in Excise Taxes 73:5
1. Definition of "Newly Discovered Oil" for Windfall Profit Tax Purposes 73:5
2. Non-beverage Distilled Spirits Imports 73:5
3. Retail Fuel and Air Transportation Tax Exemption for Helicopters 73:5
4. Sport Fishing Tax Clarification 73:6
5. Alcohol, Tobacco and Firearms Return Filing 73:6
6. Technical Amendments To Passenger Automobile Listed Property Rules And Gas Guzzler Tax 73:6
a. Passenger Automobile Definition 73:6
b. Listed Property 73:6

CHAPTER 74 CHANGES AFFECTING FINANCIAL INSTITUTIONS

I. Limitations on Bad Debt Reserves 74:1

A. Commercial Banks 74:1
1. Introduction 74:1
2. Overview 74:1
3. Detailed Analysis 74:1
a. General Rule 74:1
b. Recapture 74:2
c. Net Operating Losses Attributable to Bad Debts 74:2
4. Effective Date 74:2
B. Thrift Institutions 74:2
1. Introduction 74:2
2. Overview 74:3
3. Detailed Analysis 74:3
4. Effective Date 74:3

II. Interest Incurred to Carry Tax-Exempt Bonds 74:3

A. Introduction 74:3
B. Overview 74:3
C. Detailed Analysis and Effective Dates 74:3

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

III. **Special Loss Carryover Rules** 74:4
A. Introduction 74:4
B. Overview 74:4
C. Detailed Analysis 74:4
1. General Rule 74:4
2. Special Thrift Carryforward 74:4
D. Effective Dates 74:4
IV. **Repeal of Special Thrift Reorganization Rules** 74:5
A. Introduction 74:5
B. Overview 74:5
C. Detailed Analysis 74:5
D. Effective Date 74:5
E. Treatment of FSLIC Payments 74:5
V. **Deductibility of Losses on Deposits in Insolvent Institutions** 74:6
A. Introduction 74:6
B. Overview 74:6
C. Detailed Analysis 74:6
D. Effective Date 74:6
E. Treatment of Interest on Frozen Deposits 74:6

CHAPTER 75 — TAXATION OF INSURANCE COMPANIES AND POLICYHOLDERS

I. **Introduction** 75:1
A. Background 75:1
B. Overview and Effective Dates 75:2
II. **Property and Casualty Insurance Company Provisions** 75:3
A. Unearned Premiums 75:3
B. Proration 75:5
C. Loss Reserve Discounting 75:6
1. Overview; Scope of Discounting Requirement 75:6
2. Discounting Methodology 75:6
3. Interest Rate 75:7
4. Loss Payment Pattern 75:7
5. Special Rules 75:8
6. Effective Date; Fresh Start 75:9
D. Other Significant Changes and Studies 75:9
E. Alternative Minimum Tax 75:10
F. Certain Physician's and Surgeons' Associations 75:10
III. **Exempt Organizations Providing Insurance** 75:10
A. Organizations Providing Commercial-Type Insurance 75:10
B. Blue Cross and Blue Shield Organizations and Similar Organizations 75:11
C. Effective Date, Special Rules, and Study 75:12
IV. **Life Insurance Company Provisions** 75:13
A. Repeal of Special Deduction 75:13
B. Market Discount Bonds 75:13
C. Operations Less Deduction of Insolvent Life Insurance Company 75:14
D. Alternative Minimum Tax 75:14
1. Alternative Minimum Taxable Income — In General 75:14
a. Adjustments 75:14
b. Items of Tax Preference 75:15
c. Alternative Minimum Tax Credit 75:15
2. Alternative Minimum Tax — The Book Income Adjustment 75:15
a. The Applicable Financial Statement 75:16
b. Adjustments to Net Book Income 75:16
c. Statements Covering Different Periods 75:17
d. Miscellaneous Adjustments to Net Book Income 75:17
3. Alternative Minimum Tax — Adjusted Current Earnings 75:17
a. Inclusion of Items Included in E&P 75:17
b. Inclusion of Inside Buildup 75:18
c. Acquisition Expenses and the Small Company Deduction 75:18
d. Disallowance of Items Not Deductible for E&P Purposes 75:18
e. Miscellaneous Adjustments 75:18
4. Alternative Minimum Tax Treasury Department Study 75:19
E. Technical Corrections - Reserves 75:19
1. Contracts Without Life Contingencies 75:19
2. Contracts Without Standard Tables 75:19
3. Election Not to Have Reserves Recomputed 75:19
4. Net Level Reserves for Non-Cancellable A&H Contracts 75:19
F. Technical Corrections - Ownership Differential 75:20
1. Equity Base 75:20
2. Definition of 50 Largest Stock Companies 75:20
3. Domestic Companies Only 75:20
4. Statement Gain or Loss from Operations 75:20
5. Estimated Taxes 75:20
6. High Surplus Mutual 75:20
G. Technical Corrections - Proration 75:21
H. Technical Corrections - Variable Contracts 75:21
1. Variable Life; the "Look Through" Rule 75:21
2. Variable Contracts with Guarantees 75:22
I. Technical Corrections - Fresh Start 75:22
1. In General 75:22
2. Accelerated Policyholder Dividends 75:22
3. Other Changes with Respect to Fresh Start 75:23
J. Technical Corrections - Miscellaneous 75:23
V. **Policyholder Provisions** 75:24
A. Life Insurance Contracts 75:24
1. Withdrawals 75:24
2. Policy Loans 75:25
a. Consumer Interest 75:25
b. Revised Code Section 264 Limit 75:25
c. Single Premium Contracts 75:26
3. Installment Payments of Death Benefits 75:26
4. Definition of Life Insurance - Technical Corrections 75:26
B. Group-Term Life Insurance - Technical Corrections 75:27
1. Determination of Cost for Discriminatory Plans 75:27
2. Definition of Key Employee 75:27
3. Separate Treatment of Former Employees 75:27

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

4. Coordination with Code Section 83 75:27
5. Clarification of Effective Date 75:27
C. Nonqualified Annuity Contracts 75:28
1. Nonindividual Owners 75:28
2. Penalty Tax 75:29
3. Tax on Annuitized Payments 75:29
4. Other Annuity Provisions 75:30
a. Transfers for Inadequate Consideration 75:30
b. Mandatory Distribution Rules 75:30
D. Structured Settlements 75:30
E. Exchanges Under Section §1035 75:30

CHAPTER 76 — REAL ESTATE OVERVIEW

I. Introduction 76:1

II. Real Estate Issues in 1986 TRA 76:1

A. Rate Reduction for Individuals 76:1
B. Elimination of the Capital Gains Differential for Individual Taxpayers 76:2
C. Limitations on Deductibility of Losses and Credits from Passive Activities 76:2
D. Extension of At-Risk Limitations to Real Property 76:3
E. Installment Sales 76:4
F. Limitations on the Deduction of Investment Interest 76:4
G. Disallowance of Consumer Interest 76:5
H. Depreciation Changes — Modified ACRS System 76:5
I. Mortgage-Backed Securities; Real Estate Mortgage Investment Conduits ("REMICs") 76:6
J. Cancellation of Indebtedness 76:7
K. Investment Credit Repeal 76:7
L. Reduction and Limitation of the Rehabilitation Credit 76:7
M. Changed Low-Income Housing Incentives 76:8
N. Limitations on the Issuance of Tax-Exempt Bonds 76:8
O. Changes Affecting Foreign Ownership of U.S. Real Estate — the Branch Profits Tax 76:9
P. Construction Costs — Capitalization of Indirect Costs 76:9
Q. Contributions in Aid of Construction Received by Utilities 76:9
R. Long-Term Contract Accounting 76:9
S. REIT Rules Changes 76:10
T. Modifications to Cooperative Housing Rules 76:11
U. Other Provisions Affecting Real Estate 76:11

III. Summary and Conclusions 76:11

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 1

INCLUSIONS IN GROSS INCOME

John Freeman Blake, Esq.
Silverstein and Mullens
Washington, D.C.

I. Unemployment Compensation Benefits Included in Gross Income [Act §121]

A. Overview

In an effort to equalize the tax treatment of unemployment compensation with earned income, Act §121 repeals the limited exclusion allowed under present law for unemployment compensation benefits.

B. Detailed Analysis

Pre-TRA law provides a limited exclusion from gross income for unemployment compensation benefits received under a federal or state program (Code §85). If the sum of the taxpayer's unemployment compensation benefits and AGI does not exceed a base amount, then the entire benefit is excluded from income. The base amount is $12,000 in the case of an unmarried individual; $18,000, in the case of married individuals filing a joint return; and zero, in the case of married individuals filing separate returns. If the base amount is exceeded, then the amount of unemployment compensation benefits includible in gross income equals the lesser of (1) one-half of the excess of the taxpayer's combined income (modified AGI plus benefits) over the base amount, or (2) the amount of the unemployment compensation benefits.

Act §121 repeals the exclusion for unemployment compensation benefits. As a result, all unemployment compensation benefits are fully includible in gross income.

C. Effective Date

The change made by the Act is effective for amounts received after December 31, 1986, in taxable years ending after that date.[1]

II. Contributions in Aid of Construction Received by Utilities Includible in Gross Income [Act §824]

A. Overview

A corporation does not include in its income contributions to its capital. However, a contribution to the corporation made by a customer or potential customer to assist in the construction of a facility is taxable income to the corporation. Under pre-TRA 1986 law, certain regulated public utilities are allowed to treat contributions in aid of construction as a contribution to capital, thus not including the contribution in gross income. Act §824 eliminates this special treatment for regulated public utilities with the result that all contributions in aid of construction will be includible in the gross income of a utility. Three special exceptions apply to certain unidentified utilities for projects in process when the Act was passed.

B. Detailed Analysis

Under pre-TRA 1986 law, Code §118(b) allows certain regulated public utilities to exclude from gross income as contributions to the capital of the corporation certain contributions made by a customer or potential customer in aid of construction. The types of public utilities which are allowed to treat these payments as excludible are ones that provide electric energy, gas (through a local distribution system or transportation by pipeline), water, or sewage disposal services. The exclusion from income is only available for amounts received in kind as facilities for the utility service to be provided or (if not in kind) for amounts which are actually expended within two years of receipt to build such facilities. In addition, the exclusion is only available if the contribution is not includible in the utility's rate base for the purpose of setting utility rates. In compensation for this special exclusion, however, Code §118(b)(4) provides that property received as a contribution in aid of construction and property purchased with the proceeds of property received in aid of construction have no depreciable basis for federal income tax purposes and are not eligible for the investment tax credit.

Act §824 repeals this special exclusion. As a result, all contributions in aid of construction, even those received by a regulated public utility, are includible in the gross income of the receiving corporation. The House Ways and Means Committee Report explains that property is to be treated as a contribution in aid of construction (rather than as a capital contribution) if it is contributed to provide or encourage the provision of services to or for the benefit of the person making the contribution. A utility is considered as having received property to encourage the provision of services if any one of the following conditions are met: (1) the receipt of the property is a prerequisite to the provision of the services, (2) the receipt of the property results in the provision of services earlier than would have been the case had the property not been received, or (3) the receipt of the property otherwise causes the transferor to be favored in any way.[2]

[1] Act §151(b).

[2] *See* House Ways and Means Committee Report on H.R. 3838, "Tax Reform Act of 1985," Part I, 99th Cong., 1st Sess. 644 (1985).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Also according to the Committee Report, the person making the contribution is treated as having benefited from the contribution whether or not the benefit is directly or indirectly received. It states that the person making the contribution is treated as having benefited if any one of the following occurs: (1) the contributor is the person who will receive the services, (2) the contributor is the owner of the property that will receive the services, (3) the contributor is a former owner of the property that will receive the services, or (4) if the contributor will receive any benefit from the property that will receive the services. As an example of item (4), the Committee Report describes the situation of a builder who transfers property to a utility in order to obtain services for a house that he was paid to build even though the builder never owned the property involved.[3]

Finally, the Committee Report states that a contribution is to be treated as a taxable contribution in aid of construction whether or not the utility had previously had a general policy, stated or implied, that required or encouraged certain types of potential customers to transfer property. Rather than looking to the policies of the utility to determine whether a contribution is in aid of construction, the Committee Report states that a contribution will be treated as such if, in fact, the contributor is favored over others not making contributions. On the other hand, if the utility does require one type of customer to make contributions when other customers are not required to make contributions, the contribution will be treated as being made in aid of construction whether or not the contributor then receives preferential treatment from the utility. For example, if developers of multiple tracts of residential housing are required to made contributions but individual homeowners are not, the fact that the developers do not, in fact, receive preferential treatment does not prevent the contribution from being a taxable contribution in aid of construction.

C. *Effective Date*

The changes made by the Act are effective for all contributions made to a utility after December 31, 1986, in taxable years ending after that date.[4] The Act makes three exceptions for certain utility projects underway when the act was passed. These are explained below.

D. *Exceptions*

There are three exceptions made for certain utilities. First, up to an aggregate limit of $4,631,000, the changes made by the Act do not apply to amounts paid by the New Jersey Department of Environmental Protection for construction of alternative water supply projects. Amounts paid by the department in excess of the limit are subject to the changes made by the Act.[5] Second, an unidentified transportation authority was granted an exemption from the changes made by the Act. The transportation authority is identified as one that was created on February 20, 1967, and which was established by an interstate compact and consented to by Congress in P.L. 89-774. The exemption for this transportation authority applies to amounts paid by it pursuant to a master plan in existence on September 13, 1984, and which are designated by the authority. This special exception applies to amounts not in excess of $68,000,000.[6] Third, an unidentified partnership was given a special election to treat gain realized on the sale of assets under an indemnity agreement dated May 6, 1986, in a special manner.[7]

III. Technical Corrections to Annuity Distribution Rules [Act §1826]

A. *Overview*

TRA 1984 amended Code §72 by adding subsection (s). The purpose of the change was to standardize the type of contract that could be called an annuity. The revisions made by TRA 1984 required that if a contract was to be treated as an annuity it had to contain language specifying certain methods of distribution in the event of the death of the contract holder. The 1984 changes left open two questions: First, if an annuity is held in a qualified plan, individual retirement account or Code §403(b) plan, do the provisions of Code §72(s) have any application to the taxation of the distribution? Second, if the contract holder is a taxpayer other than an individual, how are the rules relating to required distributions in the event of the death of the contract holder to be applied?

TRA 1986 addresses these questions in a technical amendment to Code §72(s). First, the Act specifies that the provisions of Code §72(s) do not apply to annuities that are provided under a qualified plan (Code §401(a) plan), a so-called "teacher's annuity" (Code §403(b) plan), or an individual retirement account or annuity. Second, the Act specifies that if the contract holder is a taxpayer other than an individual, the rules relating to distribution in the event the contract holder dies before the entire interest is distributed will be applied with reference to the actual individual who is receiving the annuity payments, the "primary annuitant."

B. *Detailed Analysis*

Under Code §72(s), if a contract is to be treated as an annuity under Code §72, the contract must contain certain specified methods of distribution in the event of the death of the contract holder. The section requires an annuity contract to contain language that, if the contract holder dies before the annuity starting date, the entire contract amount will be distributed within five years of the death of the contract holder. However, if any portion of the contract is payable to a designated beneficiary and the distributions will commence within one year after the contract holder's death, the portion of the contract which was payable under the beneficiary designation may be paid over a period equal to the lifetime of the designated beneficiary or over a period not exceeding the beneficiary's life expectancy.[8] If payments under an annuity contract are to continue after the death of the contract holder and the contract holder dies after the annuity starting date, Code §72(s) requires that

[3] *Id.* at p. 644-45.
[4] Act §824(c)(1).
[5] Act §824(c)(2).
[6] Act §824(c)(3).
[7] Act §824(c)(4).
[8] Code §72(s)(1)(A) and (2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the payments must be made at least as rapidly as they would have been made had the contract holder lived.[9]

The Act makes two technical amendments to Code §72(s). First, the Act specifies that if the annuity is provided under a qualified plan described in Code §401(a), a plan described in Code §403(b) or an individual retirement account or annuity, the required distribution rules of Code §72(s) do not apply to the annuity.[10] The annuities provided under each of these types of plans are subject to a different set of required distribution rules.

Second, the Act specifies that if the contract holder is not an individual, the individual actually receiving the annuity payments under the contract is the measuring life used to determine whether the distribution requirements of §72(s) have been met. The individual actually receiving the annuity payments is referred to under the Act as the "primary annuitant." The primary annuitant is defined as the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract. For example, if a corporation purchases an annuity for a key employee, the key employee is the primary annuitant and his life serves as the measuring life for determining whether or not the required distribution rules of Code §72(s) have been met.[11]

C. *Effective Date*

The changes made by TRA 1986 are effective retroactively to the enactment of the 1984 act.[12] The 1984 act provisions applicable to Code §72(s) became effective six months after the date of enactment of the 1984 act. The date which was six months after the date of enactment of the 1984 act was January 18, 1985.[13] Therefore, the changes made by Act §1826 are effective for contracts issued after January 18, 1985.

IV. Technical Corrections to the Alimony Rules [Act §1843]

A. *Overview*

Prior to the 1984 tax act, the determination of whether or not payments between spouses incident to a divorce were alimony, child support, or property settlements was determined by state law. The issue was important because, under Code §215, alimony payments are deductible by the payor (and, under Code §71, includible in the income of the payee), but child support and property settlement payments are not deductible. The 1984 act made sweeping changes to this statutory scheme in an effort to standardize the types of payments that would be treated as alimony for tax purposes. The 1984 act did not disturb the basic principle that alimony is deductible by the payor and includible in the payee's gross income, but it did alter the class of payments that qualified for alimony treatment by adding several new requirements for deductibility. Two significant changes were made by TRA 1984: First, it added subsection (f) to prevent so-called "front-loading" of alimony to create disproportionately large deductions in the early years of the alimony payment period. Second, it changed subsection (b)(1)(D) of §71 to require that, for a payment to be deductible as alimony, the divorce or separation instrument must state that the payor's obligation to make payments does not extend to any period beyond the payee's death. These changes were made in an effort to prevent alimony deductions for amounts which are truly in the nature of property settlements, unrelated to the payee's support needs.[14]

Act §1843 amends the computation for determining to what an extent a payment is inappropriately front-loaded and eliminates the requirement that the divorce or separation instrument must specifically state that the payor's obligation to make payments does not extend to any period beyond the payee's death.

B. *Detailed Analysis*

TRA 1984 added Code §71(f) to provide that certain payments that were "front-loaded" would lose their status as deductible alimony payments.[15] The front-loading rules provide that any payment in excess of $10,000 per year is deductible only if the divorce or separation agreement (or court order) requires the payor to make alimony payments in at least six consecutive calendar years beginning with the year of the first payment, so long as neither spouse dies during that period and the payee does not remarry. A deduction for the first $10,000 of payments made within a calendar year is not disallowed by this rule. However, if payments are deductible in one year but in a later year (during the six-year period) the payments decrease by more than $10,000 from that prior year, then the prior year's excess payments (*i.e.*, the payments made in the earlier year that exceed the sum of the later year's payments plus $10,000) must be "recaptured" in the payor's income in the later year. To prevent double taxation, the payee is allowed a corresponding deduction equal to the "recapture" amount.

TRA 1986 §1843(c)(1) changes the tax treatment of alimony and separate maintenance payments by revising the front-loading rules of Code §71(f) to allow a greater amount of fluctuation in the amount of payments made each year. The Act reduces the recapture period for excess alimony payments from six to three years. If the total alimony paid in year one exceeds the average annual alimony paid in years two and three by more than $15,000, the excess amounts are recaptured in year three. This is achieved by requiring the payor to include the excess in income and allowing the payee who previously included the alimony in income a corresponding deduction in computing adjusted gross income. Similar recapture occurs to the extent payments in year two exceed payments in year three by more than $15,000. This recapture rule is intended to prevent payors whose divorces occur near the end of the

[9] Code §72(s)(1)(B).
[10] Act §1826(a), adding Code §72(s)(5).
[11] Act §1826(b), adding Code §72(s)(6) and (7).
[12] Act §1881.
[13] *Cf.* Tax Reform Act of 1984, P.L. 98-369, 98th Cong., 2d Sess. (1984), Act §222(c)(1).
[14] *Cf.* Tax Reform Act of 1984, P.L. 98-369, §422; and *General Explanation of the Tax Reform Act of 1984*, Staff of the Joint Committee on Taxation, p. 715.
[15] *Cf.* Tax Reform Act of 1984, P.L. 98-369, §422, adding Code §71(f).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

year from making deductible property settlements at the beginning of the next year.

Recapture of excess payments does not apply in the following situations: (1) if either party dies; (2) if the payee remarries by the end of the calendar year which is two years after the payments began (*i.e.*, the third post-separation year); (3) to temporary support payments described in Code §71(b)(2)(C); and (4) to payments which fluctuate as a result of a continuing liability to pay, for at least three years, a fixed part(s) of the earnings from a business, property or services.

Example: If the payor makes alimony payments of $50,000 in year one and no payments in years two and three, $35,000 will be recaptured, assuming that none of the exceptions to recapture apply. If, however, the payments are $50,000 in year one, $20,000 in year two, and $0 in year three, $5,000 is recaptured from year two (the excess over $15,000) and $27,500 from year one (the excess of $50,000 over the sum of $15,000 plus $7,500), the latter figure being the average payments for years two and three after reduction by the $5,000 recaptured from year two.

In addition, Act §1843(b) amends Code §71(b)(1)(D) by deleting the requirement that the divorce instrument specifically state that there is no liability to make payments after the payee's death in order to qualify the payments as alimony.

C. Effective Dates

The revised front-loading alimony rules apply to divorce or separation instruments executed after December 31, 1986. However, the parties to any divorce or separation instrument executed before 1987 may elect to have the revised front-loading rules apply by modifying the instrument after 1986 to expressly provide that the amended rules apply.[16]

For instruments to which the revised front-loading rules do not apply (*i.e.*, instruments executed before 1987 which have not been amended to make the revised rules applicable), the amount of recapture is still computed under the Code as in effect before its amendment by the Tax Reform Act of 1986, *i.e.*, there is recapture to the extent the decrease in payments in any post-separation calendar year exceeds $10,000. However, under a special transitional rule, the recapture period for making this determination has been shortened from six to three years.[17]

The amendment to Code §71(b)(1)(D) deleting the requirement that the divorce or separation instrument specifically provide that the payor has no liability to make payments for any period after the payee's death is effective retroactively for divorce or separation instruments executed after 1984.[18]

[16] Act §1843(c)(2)(A) and (B).
[17] Act §1843(c)(3).
[18] Act §1881.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 2

EXCLUSIONS FROM GROSS INCOME

John Freeman Blake, Esq.
Silverstein and Mullens
Washington, D.C.

I. Exclusion for Scholarships and Fellowships Restricted [Act §123]

A. Overview

Internal Revenue Code §117 provides an exclusion from gross income for scholarships, fellowships, and amounts received to pay the incidental expenses incurred in connection with a scholarship or fellowship. To be eligible for the exclusion, a scholarship must be paid for attendance at a qualified educational institution. Incidental expenses include amounts received and paid for travel, research, clerical help or equipment.

Act §123 limits the exclusion for scholarships or fellowship grants to "qualified scholarships." A qualified scholarship is one granted to an individual who is a candidate for a degree at a qualified educational institution, and is excludible to the extent that it is actually used for tuition and course-required fees, books, supplies, and equipment ("course-related expenses").

B. Pre-TRA 1986 Law

The exclusion under Code §117 is available to persons who are candidates for a degree and to persons who are not candidates for a degree. For both degree and nondegree students, scholarships must be granted for study at an educational institution described in Code §170(b)(1)(A)(ii) (a "qualified educational institution").[1] A fellowship grant, whether or not granted for the purpose of assisting a person in obtaining a degree, need not be used for study at a qualified educational institution.

A candidate for a degree is a person who is an undergraduate or graduate student at a college or university who is pursuing studies or conducting research to meet the requirements for an academic or professional degree, and a student who receives a scholarship for study at a secondary school or other educational institution.[2] In the case of an individual who is a candidate for a degree, the dollar amount of the scholarship or fellowship grant that may be excluded from gross income is unlimited. However, to the extent that a grant represents payment for teaching, research or other services, the grant is treated as income from part-time employment and not as an excludible scholarship or fellowship. But if teaching, research or other services are required of all candidates for a particular degree as a condition to receiving the degree, the services rendered will not be regarded as part-time employment and the scholarship or fellowship grant will continue to be excludible from gross income.[3] Much litigation has occurred over the characterization of amounts purported to have been received as a scholarship or fellowship. Amounts paid to an individual to enable pursuit of studies or research are not excludible from income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grant payor or are under the direction or supervision of the grant payor.

In the case of an individual who is not a candidate for a degree, the exclusion applies only if the grantor of the scholarship or fellowship is a tax-exempt organization, a foreign government, international organization, or government agency, and the amount of the exclusion is limited to the aggregate of the following amounts: (1) $300 per month, up to a maximum lifetime exclusion of $10,800, plus (2) the amount of incidental expenses for travel, research, clerical help, or equipment.[4]

Grants received under a federal program requiring the recipient to perform future services as a federal employee are excludible to the extent used for tuition and required fees, books, supplies, and equipment.[5] In addition, if a qualified educational institution offers tuition reduction programs to its employees on a nondiscriminatory basis, the amount of the tuition reduction is excluded from gross income.[6]

C. Changes Made by the Tax Reform Act of 1986

Act §123 limits the exclusion for scholarships or fellowship grants to "qualified scholarships." A qualified scholarship is one granted to an individual who is a candidate for a degree at a qualified educational institution, and is excludible only to the extent that it is actually used for tuition and

[1] Code §170(b)(1)(A)(ii) describes the type of educational institution to which contributions are deductible as a charitable contribution as follows: "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." This definition encompasses primary and secondary schools, colleges and universities, and technical schools, mechanical schools, and similar institutions, but not noneducational institutions, on-the-job training, correspondence schools, night schools, and other similar institutions. Regs. §§1.117-3(b), 1.151-3(c).

[2] Regs. §1.117-3(e).

[3] Code §117(b)(1).

[4] Code §117(b)(2).

[5] Code §117(c).

[6] Code §117(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

course-required fees, books, supplies, and equipment ("course-related expenses"). Any other amount of a scholarship or fellowship grant received by a degree candidate (for example, amounts for room, board, or incidental expenses) is includible in gross income, as is the full amount of any scholarship or fellowship grant received by an individual who is not a degree candidate.

The Act repeals the exception under pre-TRA law permitting scholarship or fellowship grants received by degree candidates representing payment for services to be excludible under §117 if all candidates for the particular degree are required to perform such services. Thus, amounts received that represent payment for services, whether or not the rendering of services is required as a condition of receiving the grant or as a condition of receiving a degree, are included in income. By reason of post-TRA §117(c), this inclusion rule applies both to grants received in cash and to amounts (representing payment for services) by which the tuition of the person who performs services is reduced, whether or not pursuant to a tuition reduction plan described in post-TRA §117(d).[7]

Except to the extent that a tuition reduction represents payment for services rendered, the Act leaves intact the pre-TRA exclusion for tuition reduction programs by qualified educational institutions for its employees.[8]

The repeal of the exclusion in the case of nondegree candidates does not affect whether the exclusion under Code §127 may apply to employer-provided educational assistance to nondegree candidates, or whether unreimbursed educational expenses of some nondegree candidates may be deductible as trade or business expenses if the requirements of Code §162 are met.[9]

The conference agreement accompanying the Act states that, except for students attending a primary or secondary school or pursuing a degree at a college or university, the term "candidate for a degree" means a student who receives a scholarship for study at an educational institution that (1) provides an educational program that is acceptable for full credit toward a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation, and (2) is authorized under federal or state law to provide such a program, and is accredited by a nationally recognized accreditation agency.[10]

The conference agreement also states that for purposes of the rule that a child eligible to be claimed as a dependent on the return of his or her parents may use the standard deduction only to offset the greater of $500 or earned income, any amount of a scholarship or fellowship grant that is includible in gross income as a result of these amendments to §117 (including the repeal of any §117 exclusion for nondegree candidates) constitutes earned income.[11] As a result, to the extent that a scholarship is includible in the income of a child who is under age 14, the income will be taxed at the child's marginal tax rate and not at the parent's marginal tax rate. Amounts received as payment for teaching or other services also constitute earned income.

Finally, the Act repeals the pre-TRA exception permitting the exclusion of certain federal grants under §117 even though the recipient is required to perform future service as a federal employee. Thus, to the extent the amount received represents payments for past, present, or future services required to be performed as a condition of the grant, then the amount received is includible in the recipient's gross income.

D. Effective Date

The changes made to §117 are effective for taxable years beginning after December 31, 1986, for scholarships and fellowships granted after August 16, 1986.

II. Exclusion for Prizes and Awards Restricted [Act §122]

A. Pre-TRA 1986 Law

Section 74 provides that prizes and awards other than scholarships and fellowship grants excludible under §117 are includible in gross income. However, §74 also provides a limited exclusion for prizes and awards received for achievements in fields such as the sciences, charity, or the arts. The exclusion applies only if the recipient has not applied specifically for the prize or award, for example by entering a contest, and is not required to render services as a condition of receiving the prize.

A prize or award that is includible under §74, may be excludible from gross income if it qualifies as a gift under §102. If an award to an employee constitutes a gift excludible from income under §102, the employer's deduction is limited to the amounts referred to in §274(b). Section 274(b) generally disallows business deductions for gifts to the extent that the total cost of all gifts of cash, tangible personal property, and other items to the same individual from the taxpayer during the taxable year exceeds $25. An exception to the $25 limitation provides that the ceiling on the deduction is $400 in the case of an excludible gift of an item of tangible personal property awarded to an employee for length of service, safety achievement, or productivity. In addition, the ceiling on the employer's business gift deduction is $1,600 for an excludible employee award for such purposes when provided under a qualified award plan, if the average cost of all plan awards in the year does not exceed $400.

Section 132(e) excludes from income certain *de minimis* fringe benefits, such as property or services the value of which are so small (taking into account the frequency with which similar fringes are provided by an employer to its employees) as to make accounting for them unreasonable or administratively impracticable.

B. Changes Made by the Tax Reform Act of 1986

Act §122(a) repeals the limited exclusion under Code §74 for prizes or awards for achievement in the sciences, charity and the arts, except when the recipient assigns the prize or award to a governmental unit or tax-exempt chari-

[7] H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-16 (1986) ("Conference Report").
[8] Act §123, amending Code §117(d).
[9] Conference Report, p. II-15.
[10] Conference Report, p. II-16.
[11] Conference Report, p. II-17.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

table organization. Post-TRA Code §74 provides that three conditions must be met in order for a prize or award to be excludible from gross income:

(1) the recipient must have been selected without any action on his or her part;

(2) the recipient must not be required to render services as a condition of receiving the prize or award; and

(3) the prize or award must be transferred *by the grantor* at the instruction of the recipient to a charitable organization described in §170(c)(2) of the Code, or to a governmental unit described in §170(c)(1) of the Code.

To the extent a qualifying assignment is made, the prize or award is not included in the winner's gross income, and no charitable deduction is allowed to the winner or to the payor. To the extent that a qualifying assignment is not made, the prize or award is includible in the recipient's gross income. If the recipient later makes a transfer to an exempt organization, a deduction is allowed under §170, subject to the limitations that normally apply to charitable contribution deductions.

Act §122(a) also adds subsection (c) to Code §74 to exclude employee achievement awards from the recipient's gross income. An employee achievement award is an award described in post-TRA §274(j), which is discussed *infra*.

As under pre-TRA law, if a prize is excludible under Code §132(e) as a *de minimis* fringe benefit, it will also be excludible under §74.

Act §122(b) adds subsection (c) to Code §102 which excludes from income amounts received as gifts or inheritances. Under post-TRA §102(c), no amount received by an employee from an employer is excludible from gross income.

Note: Looking at Code §§74, 102 and 132 together, it appears that an employee may exclude only those gifts from employers that are *de minimis* (as defined in §132) or that qualify as employee achievement awards (as described in Code §274(j)).

Act §§122(c) and (d) reorganize Code §274 by removing from Code §274(b) references to employee achievement awards, which in turn are dealt with in revised Code §274(j). Post-TRA §274(b) allows an employer to deduct the following three types of gifts:

(1) any gift which an employee may exclude from gross income, up to a maximum of $25 per employee, per year;

(2) any gift having a cost to the employer of $4.00 or less which has the employer's name permanently imprinted on it and which is one of a number of identical items distributed generally by the taxpayer; and

(3) any gift in the nature of a sign or display rack or other similar promotional item.

Post-TRA §274(j) deals with the definition of an employee achievement award. This change to the Code does not change the substance of the deduction previously allowed under pre-TRA §274(b), and appears to have been made for the purpose of clarifying the cross referencing from other sections (notably post-TRA §74(c)). Under the Act, as under pre-TRA law, an employee achievement award is a prize excludible from the employee's gross income (under post-TRA §74(c)), and deductible by the employer (under post-TRA §274(j)) to the extent that the cost to the employer does not exceed the amount allowable as a deduction under post-TRA §274(j). If the cost to the employer exceeds the deduction under post-TRA §274(j), then the excess amount is included in the recipient's gross income. Under post-TRA §274(j), an employee achievement award is an award given to an employee in recognition of the employee's length of service, productivity or safety achievement, the cost of which does not exceed $400, or if made under a qualified award plan does not exceed $1,600. A qualified award plan is defined as a written plan that does not discriminate in favor of highly compensated employees (as defined in post-TRA §414(q)) and which provides awards the average cost of which do not exceed $400.

Act §122(e) provides that if an employee award is excludible from wages for income tax purposes, it is also excludible for employment tax purposes and from the social security benefit base.

C. *Effective Date*

This provision is effective for taxable years beginning after December 31, 1986.[12]

III. Repeal of Exclusion for Interest on Installment Payments of Life Insurance Proceeds [Act §1001]

Under pre-TRA law, the proceeds of a life insurance policy received by a beneficiary after the death of the insured are excludible under §101. If the insurer agrees to hold the proceeds and pay them at a later date, or in installments, then the interest on the proceeds paid by the insurer are includible in the beneficiary's gross income. Each payment received by the beneficiary represents a prorata payment of both policy proceeds and interest income. However, under pre-TRA §101(d)(1)(B), if the beneficiary is the surviving spouse of the insured, the spouse receives a special exclusion for the first $1,000 received as interest in each taxable year.

Act §1001 repeals the $1,000 annual exclusion for interest on life insurance proceeds received by a surviving spouse of the insured. Under the Act, all amounts received as interest are includible in the gross income of the beneficiary. Each payment received by the beneficiary represents a prorata payment of policy proceeds and interest. In addition, if payments are to be received in installments over the lifetime of the beneficiary, the proration must be made on the basis of mortality tables prescribed by the Service which, in turn, must not distinguish among individuals on the basis of sex.

The changes made by the Act are effective for interest on insurance proceeds payable on the lives of insured individuals who die after the date of enactment of the Act (October 22, 1986), and are received in taxable years of a beneficiary which begin after the date of enactment.

[12] *Cf.* Act §151.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

IV. Exclusion for Structured Settlements Income Limited [Act §1002]

Code §104(a)(2) excludes from income damages received from personal injuries. The exclusion applies whether or not they result from an adjudication of a law suit or from a settlement with an alleged wrongdoer. The exclusion applies whether the damages are paid in a lump sum or in installments. Code §130 provides that if a defendant assigns the obligation to pay periodic payments to a structured settlements company, the defendant may deduct the lump sum payment made to the structured settlement company even though the structured settlement company will pay the damages to the injured party in installments. In turn, the structured settlement company may exclude from its income the earnings on amounts used to fund its liability to make the periodic payments to the injured party.

Act §1002(a) limits the exclusion provided under Code §130 to damages payable by reason of *physical* injury or *physical* sickness. This would include damages for wrongful death arising from physical injury and sickness, but would not include damages for such wrongs as defamation of character, or invasion of privacy.

According to the conference agreement accompanying the Act, when various causes of action are alleged, some involving physical injury or sickness and others not, there need be no proration of the damages award to determine what portion of the award is excludible under post-TRA §130. Rather, the conference agreement states that if the claim has its origin in a physical injury or sickness, all damages arising from the claim are excludible.[13]

The changes made to §130 are effective for liabilities assigned after December 31, 1986, in taxable years ending after that date.[14]

V. Capital Gains Exclusion Repealed [Act §§301, 406]

A. Pre-TRA Law

Pre-TRA §1202 provides that an individual may deduct 60% of net long-term capital gains before including the remaining 40% in gross income for the year. As a result, the highest tax payable on long-term capital gains by a 50% tax bracket taxpayer is 20% (50% of the 40% includible portion of the gain). In addition, Code §1211 provides that an individual may deduct capital losses in full to offset capital gains, and may take capital losses to offset ordinary income to the extent of $3,000 each year. However, only one-half of the excess of net long-term capital losses over net short-term capital gain is allowed to offset ordinary income. As a result, it takes $2 of long-term losses to offset $1 of ordinary income.

B. Changes Made By the Tax Reform Act of 1986

Act §301 repeals the exclusion of 60% of net long-term capital gains. As a result, all net capital gains are includible in income and taxed at the taxpayer's top marginal bracket. In 1987, net capital gains will be added to the taxpayer's other income and taxed at the lesser of the applicable tax bracket, or 28%. In 1988 and later years, however, if the taxpayer is in the "hidden" 33% tax bracket by reason of the phase out of the benefit of the 15% tax rate or personal exemption, the tax applicable to some or all of the taxpayer's net capital gains will be the higher, 33% rate. Act §302(a).

As under pre-1986 TRA law, taxpayers can offset capital losses in full against capital gains. However, for taxable years beginning after 1986, capital losses can offset up to $3,000 of ordinary income on a dollar for dollar basis. Act §301(b).

C. Implications of Repeal of Long-Term Capital Gains Exclusion

The repeal of the long-term capital gains exclusion has many implications for individual taxpayers. The removal of preferential treatment for capital gains income means that there is little incentive to convert income from ordinary income to capital gain income. Conversion of income from ordinary to capital has been a primary goal of many tax shelter transactions. For example, a taxpayer would acquire a building primarily with borrowed funds. The combination of interest and depreciation deductions, as well as operating expenses, could be structured to exceed rental income from the building. The net loss was used to offset the taxpayer's ordinary income from other sources (for example, salary, interest and dividends). Later, when the building was sold, the proceeds from the sale would produce capital gain income. The difference in tax rates applicable to the capital gain represented a significant tax savings to the taxpayer. This type of effort to convert ordinary income to capital gain income is unnecessary under the Act because the Code no longer provides preferential treatment to long-term capital gains.

The Code contains several provisions designed to limit the taxpayer's ability to convert income from ordinary income to capital gain income. These provisions, referred to as "recapture" provisions, require the taxpayer to treat a certain portion of a gain as ordinary income instead of as a capital gain. For example, under Code §1250(a), when a taxpayer depreciates property on an accelerated basis, the amount by which the depreciation taken exceeds straight line depreciation could be recaptured as ordinary income when the property was sold if the taxpayer did not hold the property for a designated period of time. The elimination of the exclusion for net capital gains ends the taxpayer's concern about recapture at ordinary income tax rates.

There are several other areas in which the elimination of the net capital gains exclusion does away with or substantially reduces the significance of issues that have been of concern to taxpayers. For example, the liquidation of a corporation ordinarily results in capital gains income to the shareholder under Code §331. However, if the corporation is a collapsible corporation, as defined in Code §341, the gain from the liquidation is treated as ordinary income to the extent of the corporation's earnings and profits. One purpose of Code §341 was to prevent the taxpayer from converting ordinary income from construction activities into capital gains income by forming a corporation to carry on the construction activities, selling the building and liquidating the corporation.

[13] *Cf.* Conference Report, p. II-340.
[14] Act §1002(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The elimination of the net capital gains exclusion is seen as a mechanism for simplifying the tax system because it removes the complexities dealing with conversion, recapture and characterization of income. However, along with simplification, the changes to capital gains taxation also result in significantly higher taxes on capital gains income. For taxpayers in the highest marginal tax brackets, the change results in a 40% increase in the tax on capital gains income. For taxpayers in the 30% tax bracket, the change represents a 133% increase in the tax on long-term capital gains. As a result, there is now a significantly greater premium attached to qualifying for certain of the provisions of the Code that permit the taxpayer to defer gain on the sale or exchange of property. The deferral provisions for like kind exchanges of property under Code §1031 or involuntary conversions under Code §1033 become increasingly attractive in light of the higher tax on capital gains. In addition, the deferral provisions for sales of a taxpayer's principal residence under Code §1034 must receive greater taxpayer attention to avoid the higher tax on capital gains that results from the Act.

It is not only the federal income tax that increases because of the elimination of the 60% exclusion for net capital gains. Many states measure taxable income by reference to federal adjusted gross income. The elimination of the capital gains exclusion increases adjusted gross income for purposes of computing state income tax as well as federal income tax. In some states, the cost of the increased state tax associated with this change is nearly as great as the additional cost of the federal tax.

It should being noted that, while the Act eliminated the 60% exclusion for net capital gains, the Code retains the statutory structure that distinguishes between ordinary income and capital gain income. The purpose of keeping the statutory structure intact is to facilitate the reinstatement of a tax rate differential between long-term capital gains and ordinary income in the future. This might occur if higher ordinary income tax rates are imposed by some later tax bill.

Even without an increase in ordinary income tax rates, the distinction between ordinary and capital gain income can still be important for certain types of income. For example, the redemption of stock in a closely held corporation under Code §§303 or 302(b) after the death of the stockholder is normally accomplished at little or no tax cost. This is because the transaction is treated as a sale or exchange, rather than a dividend distribution. The estate of the stockholder holds the stock at a basis that was stepped up to its fair market value for federal estate tax purposes. Therefore, unless there has been significant appreciation in the value of the stock after the death of the stockholder, there is little or no gain realized on the redemption. The benefit of reduced taxation that results from this characterization of the transaction continues to apply after the Act.

Finally, note that the limitation on the deductibility of capital losses gives taxpayers an incentive for characterizing gain transactions as capital in nature, since capital gains may be used to offset capital losses.

VI. Exclusion for Dividends Received by Individuals Repealed [Act §612]

Code §116 allows an individual taxpayer to exclude from income the first $100 of dividends received from a domestic corporation in a taxable year. For married taxpayers filing a joint return, the exclusion may be as high as $200—$100 excluded for the dividends received by each spouse.

Act §612 repeals the exclusion for dividends received by individuals.

The change is effective for the computation of taxable income in tax years ending after December 31, 1986.

VII. Exclusion for Certain Foster Care Payments Expanded [Act §1707]

Code §131 allows foster parents to exclude from gross income reimbursements for expenses of caring for a foster child who is under age 19. To be eligible for the exclusion, the foster child must have been placed in the home by a governmental agency or state-licensed, tax-exempt child placement agency. The exclusion applies to "difficulty of care payments" which are made for handicapped foster children. To receive the benefit of the exclusion, the foster parent/taxpayer must keep detailed records of the expenses incurred in keeping the child in order to document that the payments were, in fact, reimbursements for expenses.

In an effort to provide some relief for foster parents, Act §1707(a) extends the exclusion for foster care payments in a number of ways. First, detailed record keeping is no longer a condition of receiving the exclusion. Second, the exclusion may apply to payments made for keeping foster individuals over age 18, so long as the total number of foster individuals over the age of 18 does not exceed five individuals. For so-called "difficulty of care payments," the exclusion applies for payments made on behalf of not more than 10 persons under age 19 and not more than five persons who are over age 18.

As a relief provision, the effective date of this change in the Code is one year earlier than most of the provisions of the Act, and may affect the 1986 taxable income of a given taxpayer. The changes made by Act §1707 are effective for payments received by the foster parent after December 31, 1985.[15]

VIII. Technical Corrections to the Tax Benefit Rule [Act §1812(a)]

Code §111 contains the so-called "tax benefit rule." The tax benefit rule is designed to require taxpayers to include in income amounts received in a subsequent year if the same amount was deducted from income in a prior year. The most prevalent example of the impact of the tax

[15] Act §1707(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

benefit rule is the receipt of a state or local tax refund in a year following the year in which the taxpayer deducted the amount from federal adjusted gross income. If the deduction is based upon the amounts withheld during the taxable year, and if the ultimate state or local tax liability later turns out to be less than the amount withheld, the deduction is taken in year one and the amount of the refund is included in income in year two. In this situation, §111 requires the taxpayer to include the refund (or other tax benefit item) in income in the year received to the extent the amount exceeds the excess of itemized deductions over the zero bracket amount (standard deduction).

Inequities occur if the taxpayer had no taxable income in the year in which the deduction was available, or paid an alternative minimum tax, or who had credits which reduced tax to zero. Under pre-TRA 1986 law, such taxpayers had to include the tax benefit item in the subsequent year even though there was, in fact, no tax benefit received in the prior year.

Act §1812(a) changes the tax benefit rule so that a taxpayer is required to include a tax benefit item in income only if the taxpayer's tax was reduced in the prior year by reason of the tax benefit item. Therefore, for taxpayers who had no taxable income in the prior year, or who paid an alternative minimum tax in the prior year, or whose tax credits in the prior year reduced tax to zero, the taxpayer need not include the tax benefit item in income in the subsequent year.

This is a technical amendment to the Tax Reform Act of 1984 and is made retroactive to the effective date of the 1984 Act for this provision. Therefore, the changes made by Act §1812(a) are effective for amounts received after December 31, 1983 in taxable years beginning after that date. *See* Act §172 of TRA 1984 (P.L. 98-369).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 3

CHANGES TO THE CANCELLATION OF INDEBTEDNESS RULES

Charles E. Taylor, Esq.
Silverstein and Mullens
Washington, D.C.

I. Background

Pre-TRA 1986 Code §61(a)(12) provides that gross income includes all or a portion of the indebtedness which a creditor forgives. The amount of the forgiven indebtedness, also known as the amount discharged, equals the outstanding amount of the debt, adjusted for any unamortized premium or discount, as reduced by any consideration which the debtor gives. Under pre-TRA §108(a)(1)(C),[1] solvent taxpayers may elect to avoid recognition of income upon discharge of indebtedness incurred or assumed by a corporation, or by an individual (including partner in a partnership) in connection with property used in his trade or business. An electing solvent taxpayer must reduce its basis in depreciable assets, or, if it so elects, inventory,[2] by the amount of the debt which is forgiven. To the extent that the amount of discharged indebtedness exceeds available basis, the taxpayer must recognize that excess as income.

Insolvent taxpayers or taxpayers in Title 11 cases which do not recognize income upon discharge of indebtedness must reduce their tax credits (*i.e.*, research and general business tax credits and carryovers, and foreign tax credit carryovers) by fifty cents for each dollar of indebtedness discharged; and their net operating loss deductions, capital loss carryovers, and bases in assets by one dollar for each dollar of indebtedness discharged.[3] The reduction in aggregate bases of assets of an insolvent taxpayer may not be reduced below the amount of the taxpayers' undischarged liabilities.[4] The amount of any excess forgiven liabilities is not included in income to the extent of the taxpayer's insolvency.[5] Conversely, if an insolvent taxpayer becomes solvent (*i.e.*, liabilities no longer exceed assets) as a result of a discharge of indebtedness, the taxpayer may recognize income to the extent that it is solvent.[6]

II. Overview

The 1986 TRA makes two major changes in the rules governing discharge of indebtedness. First, solvent taxpayers no longer have the election to reduce their bases in assets instead of recognizing income upon the discharge of qualified business indebtedness. Second, certain solvent farmers are treated as insolvent taxpayers upon the discharge of indebtedness that is secured by farm property or farmland used in the trade or business of farming.

III. Detailed Analysis

A. Qualified Business Indebtedness Alternative Repealed

The 1986 TRA repeals Code §108(a)(1)(C) so that solvent taxpayers (other than certain farmers defined in new §108(g)) no longer have the election to reduce the bases of their depreciable assets or inventory instead of recognizing income upon the discharge of indebtedness.[7] The Senate Finance Committee indicated that this benefit was too generous because many taxpayers who took advantage of this provision had the capacity to pay income taxes.[8] In addition, the Senate Report states that the section could produce disparate results among similarly situated taxpayers based upon their depreciable assets on hand. If a taxpayer did not have substantial basis in depreciable assets or inventory, it could not avail itself of this tax deferral technique.

The pre-TRA rules of §108 will continue to apply to insolvent taxpayers and taxpayers in Title 11 proceedings. Section 108(e)(5) will continue to apply to solvent taxpayers and allow them to treat any reduction in purchase money indebtedness as an adjustment of the purchase price rather than a discharge of indebtedness.

This amendment is applicable to discharges of indebtedness occurring after December 31, 1986.[9]

B. Discharge of Trade or Business Debts of Solvent Farmers

Congress has enacted a program to make payments to lending institutions holding federally guaranteed farm

[1] All section references in this chapter are to the Internal Revenue Code of 1986 and the regulations thereunder unless otherwise specified. All Act section references in this chapter are to sections of the Tax Reform Act of 1986, P.L. 99-514, (hereinafter sometimes referred to as the "1986 TRA").

[2] §1017(b)(3)(E).

[3] Pre-TRA §108(b).

[4] H.R. Rep. 841, 99th Cong., 2d Sess., II-116 (Sept. 18, 1986) (hereinafter referred to in this chapter as the "Conference Report").

[5] Pre-TRA §108(a)(3). *See* Conference Report, p. II-116.

[6] *Cf. See* Conference Report, p. II-324.

[7] Act §822(a).

[8] S. Rep. 313, 99th Cong., 2d Sess. 161 (May 29, 1986) (hereinafter referred to in this Chapter as the "Senate Report"). The House of Representatives bill, H.R. 3838, did not contain a provision similar to that in the Senate Amendment.

[9] Act §822(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

loans if the lender will reduce the interest charged to the farmer (presumably below a market rate of interest).[10] The Senate Finance Committee was concerned that farmers who were marginally solvent might be forced to recognize substantial amounts of income from participating in programs of a similar nature which would reduce a portion of their debt.[11] Such a result would discourage use of federal programs designed to assist hard-pressed farmers.

Code §108(g) defines certain solvent farmers as insolvent taxpayers when there is a discharge of qualified farm indebtedness by an unrelated creditor.[12] New Code §108(g)(2) provides that qualified farm indebtedness must be incurred directly in connection with the taxpayer's operation of a trade or business of farming. The Senate Report, p. 272, states that this includes the production of agricultural products (including timber) or livestock in the United States. Merely using farmland or farm equipment as security for the indebtedness may not be sufficient if the loan proceeds are not used in the operation of the farming business.[13] In the three taxable years preceding the discharge, the farmer must have derived one-half or more of his average annual gross receipts from farming.[14] The creditor may not be related to the taxpayer within the meaning of §465(b)(3)(C), may not have sold the property to the farmer (or be related to the seller), or receive a fee as a result of the farmer's purchase of the property.[15]

Solvent farmers will use a different ordering sequence for reduction of tax attributes and basis of assets than that applied to insolvent taxpayers or taxpayers in Title 11 proceedings. First, under §1017(b)(4) the farmer will reduce the value of his net operating losses and carryovers, general business credits and carryovers, capital losses and carryovers and foreign tax credit carryovers by the amount of indebtedness forgiven. To the extent that forgiven indebtedness has completely absorbed the tax attributes, the taxpayer will then reduce his basis of his property in the trade or business other than his farmland. Finally, the farmer will reduce his basis in his land used, or held for use, in the farming business.[16] As under pre-TRA law, there is the limitation that the reduction in the taxpayer's basis should not exceed that amount necessary to cover the taxpayer's undischarged liabilities.[17] The amount of any excess discharged indebtedness that has not been applied to reduce tax attributes or bases will not be included in income.[18]

This provision is effective for discharges of indebtedness occurring after April 9, 1986, in taxable years ending after such date.[19]

[10] Food Security Act of 1985, P.L. 99-198, 99 Stat. 1354 §1320.
[11] Senate Report at 272.
[12] Act §405(a); Senate Report at 272.
[13] *See* §108(g)(2) added by Act §706 of the Senate Amendment to H.R. 3838 which allowed a farmer's debt to qualify if it was merely secured by farmland or farm equipment. This provision was dropped in the Conference Committee.
[14] New Code §108(g)(2). A provision in the Senate Finance Committee bill that originally would have required that a qualified individual have indebtedness equal to at least 70% of the value of his assets was dropped prior to passage of the Senate Amendment. *See* Senate Report at 272.
[15] New Code §108(g)(3). *See* §46(c)(8)(D)(iv). Note that even though the investment tax credit has been repealed, (*see* Act §211, §49 of the 1986 Code) §46 has not been repealed and the definition in this section remains in the Code.
[16] New §1017(b)(4).
[17] *See* Regs. §1.1017-1(a).
[18] Conference Report at II-116. *See* Senate Report at 162 (note 49).
[19] Act §405(c).

Chapter 4

REVISION OF THE ACCELERATED COST RECOVERY SYSTEM AND EXPENSING

Patrick G. Dooher, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. *Pre-ACRS Depreciation*

The enactment of the Accelerated Cost Recovery System (ACRS) in 1981 [1] substantially altered and simplified the depreciation system for tangible property. Under the law in effect before the ACRS, a taxpayer was required to recover the cost of the depreciable asset over the period it was used to produce income in the taxpayer's business or investment activity. Because of the difficulty in accurately determining this period of usefulness, *i.e.*, the asset's useful life, taxpayers and the Service were often at odds.[2] Attempts to eliminate the uncertainty concerning useful life were made by promulgating depreciation systems with somewhat arbitrary, but audit-proof, useful lives for large groups of assets. The Class Life Asset Depreciation Range System, known as the ADR System and established as a result of the enactment of Code §167(m) in 1971, was one such system. However, comparatively few taxpayers elected to use these systems because of their complexity.

Note: An overview and detailed analysis of the useful life depreciation system is provided in 62 T.M., *Depreciation — Basis, Useful Life, Salvage,* and 412 T.M., *Depreciation Methods; Item and Group Accounts.* The ADR System is completely analyzed is 255 T.M., *Depreciation: ADR System for Post-1970 Property.*

Another problem with the prior depreciation systems was the requirement that a salvage value be estimated. Generally, total depreciation was limited to the cost or other basis of the property less a reasonable estimate for salvage value. Although a minimum salvage value could be disregarded in computing the depreciation allowance for personal property,[3] the salvage value requirement was an additional source of uncertainty and controversy.[4]

Finally, there was a concern that the prior depreciation systems diminished the incentive to make capital investments because the cost of the investments was recoverable for tax purposes through depreciation deductions computed over lengthy recovery periods.

B. *Accelerated Cost Recovery System (ACRS)*

1. *Economic Recovery Tax Act of 1981 (ERTA)*

In response to the foregoing concerns, the ACRS was enacted to replace the useful life and ADR systems of depreciating tangible property.[5] Under the ACRS, which will continue to apply to property placed in service through 1986, the cost of most §1245 property (generally personal property) is recovered over a 3-year, 5-year, 10-year or 15-year period, depending on the type of asset. As initially enacted, eligible real property was placed in a separate 15-year class, except limited types of real property might be classified as 5- or 10-year property.

Provided the property is classified correctly, the recovery period is not subject to challenge. Taxpayers, however, are afforded some flexibility through an election to use longer recovery periods. Moreover, the entire cost of eligible property may be recovered under the ACRS; the salvage value concept is eliminated.

Property eligible for the ACRS, termed "recovery property," generally includes all tangible depreciable property placed in service after 1980. Property depreciated under a method not expressed in terms of years (*e.g.*, unit-of-production) is excluded as "recovery property." More importantly, broad "anti-churning" rules applied to exclude as recovery property much property that was owned or used by a taxpayer, or person related to the taxpayer, before 1981. These anti-churning rules are found in §168(e)(4). Finally, property that the taxpayer properly elects to amortize (*e.g.*, leasehold improvements or low-income housing rehabilitation expenditures), although not excluded as "recovery property," is not taken into account in computing the ACRS deduction to the extent the basis of the property was subject to amortization.

The annual ACRS deduction for §1245 property is calculated by applying a statutory percentage, based on the 150% declining balance method with a change to the straight-line method to maximize the deduction, to the unadjusted basis of the property. For eligible real property, the recovery percentages for determining the ACRS deduction are prescribed by the Service in tables based on the 175% declining balance method with a change to the straight-line method to maximize deductions.

In lieu of using the accelerated recovery percentages for eligible §1245 or real property, taxpayers are provided

---

[1] P.L. 97-34, §201, adding §168 of the Code.

[2] *E.g., Dielectric Motors Co. v. Comr.*, 57 T.C. 587 (1972); *Casey v. Comr.*, 38 T.C. 357 (1962), acq., 1963-1 C.B. 3.

[3] *See* Code §167(f); Regs. §1.167(f)-1(c), *Example (1).*

[4] *E.g., Estate of Bryan v. Comr.*, 22 T.C.M. 864 (1963), aff'd, 364 F.2d 751 (4th Cir. 1966).

[5] P.L. 97-34, §201, adding Code §168.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

an election to use the straight-line method over the regular recovery period or over optional longer periods.

The ACRS also provided taxpayers with an election to expense a limited amount of new business property commencing in 1982 under §179. The election could only be made with respect to property qualifying for an investment credit and resulted in a forfeiture of the investment credit to the extent of the amount expensed.[6]

2. Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Changes

Incorporated in the initial provisions of the ACRS, in Code §168(f)(8), was a readily utilizable method of transferring tax benefits, including ACRS deductions and investment credits, called "safe harbor leasing." Because of the ease and the certainty of transferring otherwise unusable tax benefits under the safe harbor leasing rules, safe harbor leasing transactions proliferated and generated considerable controversy. As a result of the controversy, Congress in 1982 made the rules substantially more stringent for most safe harbor leases entered into after July 1982.[7] Moreover, the safe harbor provisions were repealed for transactions entered into after 1983, although new finance lease rules were to come into effect in ensuing years.

Also in 1982, Congress required the use of the straight-line method to the extent property is financed with the proceeds of tax-exempt industrial development bonds, effective generally for property placed in service after 1982.[8]

3. 1984 Tax Reform Act Amendments

In the 1984 Tax Reform Act,[9] Congress returned to the provisions of the ACRS, this time to focus on real estate and tax-exempt entity transactions. The assignment (in 1981) of an audit-proof 15-year recovery period for real estate, which was estimated to be one-half the economic life of real property[10] and the assignment of rapid declining-balance recovery rates, 175% for most building and structures (200% for low-income housing), was a prime factor in the explosive growth of the real estate tax shelter industry in the early 1980's. Congress also found that this more rapid depreciation led to the churning of existing property through sale and leaseback transactions as well as prompting the growth of the real estate tax shelter industry.[11] When combined with other real estate tax advantages, such as interest deductions, favorable recapture rules, and the availability of the installment method on the sale of real property, a real estate shelter was found to achieve a low or even negative effective tax rate, thereby encouraging the growth of uneconomical real estate projects.[12] Consequently, Congress lengthened the recovery period of real property to 18 years in the 1984 Act, effective generally for property placed in service after March 15, 1984. P.L. 98-369, §111(a) and (g).

An additional change made by the 1984 Tax Reform Act affecting real property was the institution of a half-month convention for all real property except low-income housing. The pre-1984 rules provided for a full month's worth of cost recovery on 15-year real property regardless of the day during the month that the property was placed in service. The mid-month convention provides only a half-month's worth of cost recovery; however, it also allows a half-month's cost recovery deduction for the month in which the real property is disposed of. The mid-month convention was generally effective for property placed in service after June 22, 1984.[13]

A second significant revision in ACRS rules by the 1984 Tax Reform Act was made with respect to tax-exempt entities.[14] The tax-exempt entity rules were prompted by a concern that, although tax-exempt entities were generally ineligible to claim the tax benefits arising from property ownership because they paid no tax, lessors could indirectly make these benefits available to tax-exempt entities by way of reduced rents. Congress was also concerned about the fact that favorable tax benefits were encouraging tax-exempt entities to dispose of their property and give up ownership control of their assets.[15] Under the rules enacted in §168(j), property leased to tax-exempt entities was subject to much less generous cost recovery schedules than those generally provided under the ACRS.

Finally, the 1984 Act added §280F of the Code to restrict the amount of ACRS deductions for so-called "luxury automobiles" and other "listed property" (generally, property susceptible of personal use). The initial maximum limitations under §280F(a)(2), for luxury automobiles was $4,000 for the first year and $6,000 for each succeeding year. However, in 1985 the cap was reduced to $3,200 for the first recovery year and $4,800 for each succeeding recovery year.[16]

4. 1985 Legislation

In 1985, Congress further lengthened the real property recovery period to 19 years, effective generally for property placed in service after May 8, 1985.[17] The purpose of this change was to pay for the liberalized imputed interest rules enacted by Congress in the same bill.[18]

Even after the foregoing changes, real property continued to be favorably treated under the ACRS. The 175% declining balance continued to apply to 19-year property; where employed, approximately 50% of the cost of the real property would be recovered within a 7-year period.[19] Moreover, the recovery period for low-income housing remained at 15-years, using 200% declining balance rates, which allows the deduction of one-half the cost of low-income housing within five years.[20] Moreover, §167(k) permitted low-income housing rehabilitation expenditures up to a certain amount to be written off over a 60-month period.

C. Overview of Revised ACRS

Although denominated a "modification" of the ACRS,

[6] §§179(d)(1); 168(d)(1)(A)(ii)(II).
[7] P.L. 97-248, §208.
[8] P.L. 97-248, §216.
[9] P.L. 98-369, §111.
[10] S. Rep. No. 169, 98th Cong., 2d Sess. 460-461 (1984).
[11] *Id.*
[12] *Id.*
[13] P.L. 98-369, §111(d) and (g)(5).
[14] P.L. 98-369, §31, enacting Code §168(j).
[15] *See* S. Rep. No. 169, 98th Cong. 2d Sess. 123, 125-127 (1984).
[16] P.L. 99-44, §4(a), effective generally for automobiles placed in service after April 2, 1985.
[17] P.L. 99-121, §103.
[18] H.R. Rep. No. 87, 99th Cong. 1st Sess. 12 (1985).
[19] *See* Rev. Proc. 86-6, 1986-1 C.B. 503, Table 1.
[20] *Id.*, Table 6.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the 1986 TRA version of the ACRS represents a complete revision of §168 and the ACRS.[21] Under the House passed bill,[22] revised §168 was identified as a completely new depreciation system called the "Incentive Depreciation System." Under the Senate passed version,[23] revised §168 was simply called a "modification" of the ACRS. Notwithstanding the difference in terminology, the House and Senate versions bore a stronger resemblance to each other than they did to the existing ACRS. The final version adopted by the Conference Committee generally represents a blending of the House and Senate versions, and, consequently can be regarded as a completely new depreciation system for tangible property to which the system applies.

Both the House Ways and Means Committee and the Senate Finance Committee Reports indicate that one of the purposes of their proposed depreciation systems was to lengthen depreciation periods in order to reflect more accurately the actual useful life of property.[24] The revised ACRS is consistent with this purpose. In particular, the revised ACRS lengthens the recovery period for residential rental property to 27.5 years and for most other real property, called nonresidential real property, to 31.5 years. Section 1245 property (generally personal property) is treated less harshly, as the 3, 5, 10, and 15-year categories are retained in the revised ACRS. However, two new categories, a 7-year category and a 20-year category, are added. The revised ACRS modifies the classification criteria used in determining the ACRS category into which a particular item of §1245 property will fall. Unless the statute specifically assigns a particular asset to an ACRS class, the classification will be based primarily upon the ADR class life assigned to the asset. The requirement under the existing ACRS that property be classified as either "§1245 class property" or as "§1250 class property" is generally eliminated. However, a determination of whether a particular item constitutes §1250 property (generally real property) may be necessary in determining the ADR class life of the item and whether the item constitutes nonresidential real property. The net effect of the changes in the classification rules under the revised ACRS is to place much §1245 property in ACRS classes having a longer recovery period. The most notable example, perhaps, is that property without a class life will be treated as 7-year property under the revised ACRS; the pre-1986 TRA ACRS treats such property as 5-year property.

The revised ACRS eliminates both the statutory accelerated percentages for §1245 property and the Service's authority under which accelerated percentages are prescribed for real property and optional straight-line percentages prescribed for all ACRS property. The revised ACRS provides that taxpayers must determine the ACRS deduction by using (i) the applicable depreciation method, (ii) the applicable recovery period, and (iii) the applicable convention.

The applicable recovery period for property other than real property under the revised ACRS conforms to the class into which the item of property is assigned; *i.e.*, 3-year property is recovered over 3 years. The applicable rate for 3 through 10-year property is the 200% declining balance method. Use of this rate is one change under the revised ACRS more favorable than the pre-1986 TRA system, which incorporates in the statutory percentages the 150% declining balance method for 3 through 10-year property. The rate for 15-year and 20-year property under the revised ACRS is the 150% declining balance method. Under both the 200 and 150% declining balance methods used in the revised ACRS, a switch is made to the straight-line method at the point where the straight-line method yields a greater recovery deduction.

For nonresidential property and for residential rental property, the revised ACRS requires the use straight-line method. Thus, accelerated recovery of real property is eliminated.

The revised ACRS generally retains as the applicable convention the half-year convention for §1245 property and the mid-month convention for residential rental and nonresidential real property. For the 3 though 20-year classes, however, the revised ACRS institutes a mid-quarter convention which must be applied when more than 40% of the assets placed in service during a taxable year are placed in service in the fourth quarter of that year. Under the mid-quarter convention, property placed in service during any quarter of a taxable year (or disposed of during any quarter of a taxable year) is considered placed in service (or disposed of) on the mid-point of such quarter.

Under the revised ACRS, salvage value continues to be disregarded completely in computing the recovery deduction. However, in a change from the pre-1986 TRA ACRS, the short-taxable year rule requiring pro-ration of the ACRS deduction based upon the number of months in the short year is eliminated.

The revised ACRS provides for an "alternative depreciation system" for various types of property that under the pre-1986 TRA ACRS are subject to special limitations. The types of property for which the "alternative depreciation system" must be used include:

(i) Tangible property used predominantly outside the U.S. during the taxable year;

(ii) Any tax-exempt use property; and

(iii) Any tax-exempt bond financed property.

In addition, a category of property, Executive order import property, is added. This is property that an Executive order specifies is imported from a country that discriminates in its U.S. trade.

The recovery period for property subject to the alternative depreciation system is generally the ADR class life. Personal property with no assigned class life is provided a recovery period 12 years and real property is generally assigned a recovery period of 40 years. The applicable depreciation method in all cases is the straight-line method. The applicable convention is the convention that would ordinarily be used under the revised ACRS — the half-year convention, the mid-month convention, or the mid-quarter convention as the case may be.

[21] P.L. 99-514, §201-203. P.L. 99-514 is hereinafter referred to as "1986 TRA."
[22] H.R. 3838, §201.
[23] H.R. 3838, §201.
[24] H. Rep. No. 426, 99th Cong., 1st Sess. 59 (1985); S. Rep. No. 313, 99th Cong., 2d Sess. 7 (1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The alternative depreciation system is used in determining a corporate taxpayer's earnings and profits under revised §312(k)(3). This system is also used in determining the depreciation adjustment for minimum tax purposes under revised §56(a)(1), but with the modification that the preference for §1245 real property is determined using the 150% declining balance rate in lieu of the straight-line rate.

Two elections are provided to taxpayers under the revised ACRS. First, as to property placed within one of the 3 through 20-year classes, the taxpayer may elect the straight-line method (using the regular "applicable recovery period, *i.e.*, 3 through 20 years) for all property within that class for that year rather than the 200 or 150% declining balance method, as the case might be. Second, the taxpayer may elect to use the alternative depreciation system with respect to all property placed in service in one of 3 through 20-year classes and, in the case of nonresidential real property or residential rental property, the taxpayer may elect the alternative depreciation system with respect to each property.

In a departure from pre-1986 TRA law, the revised ACRS requires that leasehold improvements, whether owned by the lessor or lessee, be depreciated in accordance with the rules of the system. The option available to lessees under the pre-1986 TRA ACRS of amortizing leasehold improvements over the lease term is eliminated.

The expensing provisions of §179 were also modified by the 1986 TRA[25] to increase the amount of qualifying investment that may be expensed from $5,000 to $10,000. However, an amount expensed under revised §179 may only offset active business income. In addition, for every dollar of qualifying investment exceeding $200,000, the $10,000 limit is reduced by one dollar.

To conform the luxury automobile rules of §280F to reclassification of automobiles from the 3-year to the 5-year class under the revised ACRS, the luxury auto cap is reduced to $2,560 for the first taxable year of the recovery period, $4,100 for the second taxable year, $2,450 for the third taxable year, and $1,475 for each succeeding taxable year in the recovery period. 1986 TRA, §201(d)(4)(A).

Finally, the 1986 TRA completely repeals the finance lease rules, which were to be the successor to the old safe-harbor rules but which never became effective generally.

D. Statutory Outline of Revised §168

Because the 1986 TRA completely revises the ACRS, it may be helpful to review in brief the structure of revised §168.

Revised §168(a) provides that except as otherwise provided in §168, the §167(a) depreciation deduction for any tangible property is determined by using the applicable depreciation method, the applicable recovery period, and the applicable convention.

Revised §168(b) sets forth the applicable depreciation method. As previously mentioned, this is the 200% declining balance method for the 3 through 10-year categories, the 150% declining balance method for the 15 and 20-year categories, and the straight-line method for real property. It also provides that the straight-line method may be elected for the 3 through 20-year classes and that salvage value is to be treated as zero in determining the recovery deduction.

Revised §168(c) sets forth the applicable recovery periods ranging from 3 through 31.5 years for 3-year property through nonresidential real property.

The applicable convention is set forth in revised §168(d). It is either the half-year or mid-quarter convention for the 3 though 20-year classes and the mid-month convention for real property.

Revised §168(e) contains the classification rules, which for the 3 through 20-year classes are generally based upon the ADR life. It also specifically assigns certain property to the 3-year, 5-year, 7-year, 15-year and 20-year classes.

Revised §168(f) sets forth the types of property which are excluded from the revised ACRS. Excluded is property for which a proper election is made to depreciate the property under a method not expressed in a term of years. Public utility property for which the taxpayer does not use a normalization accounting method, motion picture films, video tapes, and sound recordings are also included. Additionally, somewhat complex anti-churning rules are incorporated by reference from old §168(e)(4) to exclude certain property from the benefits of the revised ACRS.

The alternative depreciation system is found in revised §168(g). This section also sets forth the definition of tax-exempt bond financed property, property used predominantly outside the U.S., and Executive order imported property. It also specifies that the election of the alternative depreciation system may be made as to any class of 3-20 year property for a particular taxable year and may be made property-by-property for items of real property.

Revised §168(h) sets forth a detailed definition of "tax-exempt use" property. The definition is substantially the same as that found in old §168(j).

Revised §168(i) contains definitions and special rules to be used in applying the revised ACRS. It sets forth the definition of the ADR class life and generally authorizes the Treasury Department to modify or prescribe new class lives. It allows mass asset accounting principles to be used for most property to which revised §168 applies. It grants regulatory authority to determine the depreciation deduction for any taxable year where the status of such property changes in the taxpayer's hands. It requires that additions and improvements to property be depreciated under the revised ACRS in the same manner as if the property had been placed in service at the same time as the addition or improvement. It requires transferees in certain nontaxable transactions to continue using the same revised ACRS method as the transferor to the extent of carryover basis. It also sets forth the rule eliminating the amortization of leasehold improvements by lessees and describes what constitutes a normalization method with respect to public utility property.

E. Effective Dates

1. General

The revised ACRS generally applies to property placed in service after December 31, 1986, in taxable years ending

[25] P.L. 99-514, §202.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

after that date.[26] Broad transition rules are provided, however, for certain property under contract or under construction as of March 1, 1986, or that was to be provided under a lease or services agreement in effect on March 1, 1986.[27] Additionally, any rehabilitation property subject to the rehabilitation credit transition rules is exempted from the revised ACRS.[28] The transition rules of general application are described in detail below. Other transition rules are provided that generally apply only to specific taxpayers or specific property,[29] and accordingly are not described here.

For purposes of the treatment of tax-exempt bond financed property under the alternative depreciation system, special transition rules are provided. These transition rules are reviewed in the Detailed Analysis of the alternative depreciation system, below.

Finally, the 1986 TRA provides taxpayers with an election to apply the revised ACRS to any item or items of property placed in service during August through December 1986. This election, and the planning opportunities it presents, are described in detail below.

2. Transition Rules

a. Categories of Property

(i) General

Provided an ADR class life and placement in service requirement is satisfied, the following categories of property are not subject to the revised ACRS:[30]

(a) Any property constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract that was binding on March 1, 1986;

(b) Property that is constructed or reconstructed by the taxpayer, if (a) the lesser or $1 million or 5% of the cost of such property has been incurred or committed by March 1, 1986, and (b) the construction or reconstruction of the property began by March 1, 1986; or

(c) An equipped building or plant facility if (a) construction commenced as of March 1, 1986, pursuant to a written specific plan, and (b) more than one-half of the cost of the equipped building or facility was incurred or committed by March 1, 1986.

(ii) Binding Contracts

The Conference Report [31] elaborates at length upon the binding contract rule. The Report provides that, if a taxpayer transfers his rights in any property subject to the binding contract that is under construction or transfers his rights in the contract to another taxpayer, the revised ACRS will not apply to the property in the hands of the transferee taxpayer provided the property was not placed in service by the transferor before the transfer period.[32] Moreover, if a partnership terminates under §708(b)(1)(B) by reason of sales or exchanges of partnership interests, the partnership is to be treated as having transferred its rights in the transition rule property to the new partnership. (Conference Report, at II-55.)

> *Example:* Assume a partnership signed a binding contract to construct real property on or before March 1, 1986. Subsequently, but before the time the property is placed in service, interests in the partnership are sold or exchanged. If, by reason of such sales or exchanges, the partnership terminates and a new partnership is deemed formed under §708(b)(1)(B) (relating to sales or exchanges of 50% or more of the total interests in the partnership's capital or profits) the partnership is treated as having transferred its rights in its contract or the property to the new partnership for purposes of binding contract transition rule.

The Conference Report further states that the binding contract rule applies only to contracts in which the construction, reconstruction, or acquisition of property is itself the contract subject matter. Moreover, a contract is to be considered binding only if it is enforceable under state law and does not limit damages to a specified amount, such as in a liquidated damages provision. But a contract limiting damages to an amount equal to at least 5% of the total contract price will not be treated as limiting damages. A contract granting the taxpayer an option to acquire property is not to be treated as a binding contract to acquire the property, but a contract under which the taxpayer grants an irrevocable put (an option to sell) to another taxpayer is considered a binding contract since the grantor of the put option does not have the ability to rescind unilaterally the commitment to sell. A contract subject to a condition not within the control or either party or a predecessor (except in limited circumstances described below) is considered binding. A contract binding as of March 1, 1986, will not be considered binding at all times thereafter if substantially modified after that date. However, design changes to a binding construction contract that are made for reasons of technical or economic efficiencies of operation and that cause an insignificant increase in the original contract price will not constitute substantial modification of the contract. Additionally, a supplementary contract that stands on its own and does not govern by the binding contract rule will not adversely affect the status of the portion of the property subject to the binding contract transition rule.[33]

The Report further states that a binding contract to acquire a component of a larger property will not be treated as a binding contract to acquire the larger property for purposes of the transition rule. For example, a binding written contract entered into before March 2, 1986, to acquire an aircraft engine would not be treated as a binding contract to acquire the entire aircraft.[34]

(iii) Self-Construction

For purposes of the transition rules concerning self-constructed property — *i.e.*, the property under construction or reconstruction by the taxpayer if (i) lesser of $1 million or 5% of the property's cost was incurred or committed pursu-

[26] 1986 TRA, §203(a)(1)(A).
[27] 1986 TRA, §§203(b) and 204(a)(3).
[28] 1986 TRA, §§203(a)(1) and 251(d)(2).
[29] *See* 1986 TRA §204.
[30] 1986 TRA, §203(b)(1). *See* 1986 TRA, §203(b)(2).
[31] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-54-56 (1986) ("Conference Report").
[32] *Id.*, at II-55. In what appears to be typographical error, the Conference Report refers to placement in service by the transferee, rather than the transferor. *Id.*
[33] *Id.*, II-55.
[34] *Id.*

ant to a binding written contract in effect as of March 1, 1986, and (ii) construction or reconstruction of which began by that date — the construction or property is considered to begin when physical work of a significant nature starts. Construction has not begun if work has started on only minor parts or components. Moreover, physical work does not include preliminary activities such as planning or designing, financing, exploring, researching, or developing.[35]

For purposes of the self-constructed property transition rule, a building is to be treated as including all the normal and customary components that are purchased from others and installed without significant modification, such as light fixtures.[36]

(iv) Equipped Buildings and Plant Facilities

An equipped building or plant facility may qualify for transition relief if it was under construction as of March 1, 1986, pursuant to a written specific plan and more than 50% of the building or facility cost was incurred or committed by March 1, 1986. Act §203(b)(1)(C).

The Conference Report provides that if an equipped building fails the more-than-50% test, each item of machinery and equipment to be installed in the building is treated separately for purposes of determining whether that item qualifies for transition relief. If, however, the more-than-50% test is satisfied, "incidental appurtenances," as well as equipment and machinery installed in the building, is excluded from the revised ACRS. The Report describes incidental appurtenances as appurtenances which are incidental to the operations carried on in the building but that are not themselves located in the building. For example, an adjacent railroad siding, a dynamo or water tower used in connection with a manufacturing process, or other incidental structures or machinery and equipment necessary to the planned use of the building, may qualify as incidental appurtenances. However, the term "appurtenances" does not include a plant needed to supply materials to be processed or used in the building under construction. Significantly, the Conference Report makes it clear that the incidental appurtenances which will be subject to the transition rule are not to be counted in determining whether the equipped building satisfies the more-than-50% test.[37]

The written plan for the equipped building must be, according to the Conference Report, a definite, specific, written plan of the taxpayer that is available as evidence of the taxpayer's intentions. The written plan may be modified, but only to a minor extent, after March 1, 1986. If substantial modifications in the plan are made, the equipped building transition rule will not apply.[38]

The plant facility rule is designed to be comparable to the equipped building rule and to apply to facilities not housed in a building.[39] The transition rules [40] define a "plant facility" as a facility not including any building (or with respect to which buildings are an insignificant portion) and which is (i) a self-contained single operating unit or processing operation, (ii) located on a single site, and (iii) identified as a single unitary project as of March 1, 1986.

The Conference Report states that construction of a plant facility (which is required to have begun by March 1, 1986, to qualify under the rule) is not considered to have begun until it has commenced at the site of the plant facility, unless the facility is not to be located on land and, consequently, the initial work on the facility must begin elsewhere. Construction of the plant facility is deemed to begin only when actual work at the site commences. For example, when work begins on the excavation for footings, or pouring the pads for the facility, or driving the foundation pilings into the ground, then construction is deemed to begin. Preliminary work, such as clearing, test drilling, or excavation to change a land contour, is not treated as the commencement of construction.[41]

(v) Supply and Service Contracts; Leases

Another transition rule of general effect provides that the revised ACRS does not apply to any property that is "readily identifiable with and necessary to carry out a written supply or service contract, or agreement to lease," that was binding on March 1, 1986.[42] The Conference Report explains that this transition rule is provided for those situations where pre-March 2, 1986, written binding contract requires the construction or acquisition of property but the contract is not between the person who will own the property and the person who will construct or supply the property. The Report further states that the rule applies only where the specifications and amount of the property are readily ascertainable from the contract terms or related documents. A supply or service contract or lease agreement must satisfy the various, previously-described requirements for a binding contract, such as that no substantial modifications be made to the contract after March 1, 1986. A change in the method or amount of compensation for services under the contract will not be considered a substantial modification if, taken as a whole, the change does not affect the scope or function of the project. If additional property is included under a supply or services contract or lease agreement after March 1, 1986, the transition rule will not apply to the additional property.[43]

The Conference Report gives as an example of a lease agreement to which the transition rule could apply a finance lease (to the extent the transition rules continue to permit finance leases) under which a grantor trust is obligated to provide property. The Report also clarifies that the transition relief will apply to cable television franchise agreements embodied in whole or in part in municipal ordinances or similar enactments before March 2, 1986.[44]

b. Class Life and Placement in Service Requirements

The foregoing transition relief is not available unless two additional requirements are satisfied.[45] The first requirement is that the property have an ADR class life of at

[35] *Id.*, at II-56.
[36] *Id.*
[37] *Id.*, at II-56 and 57.
[38] *Id.*, at II-57.
[39] *Id.*, at II-57.
[40] 1986 TRA, §203(b)(4).
[41] Conference Report at II-58.
[42] 1986 TRA, §204(a)(3).
[43] Conference Report, at II-59 and 60.
[44] *Id.*
[45] 1986 TRA, §203(b)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

least 7 years. The second requirement is that the property be placed in service by an applicable date based upon the property's ADR class life. For property with an ADR life of at least 7 years but less than 20 years, the applicable date is January 1, 1989. For example, a bus, which has a 9 year ADR class life [46] or a tugboat, which has an 18 year ADR class life,[47] which was under a binding purchase contract on or before March 1, 1986, must be placed in service by December 31, 1988, to qualify. The applicable placement in service date for property with a class life of at least 20 years is January 1, 1991. Thus, an item such as a billboard, which has a 20-year ADR class life,[48] must be placed in service by December 31, 1990. Finally, the applicable date for residential rental property and nonresidential real property is January 1, 1991.

Property with no class life is treated as having a class life of 12 years.[49] Moreover, any property to be provided under a supply or services contract or lease agreement is treated as having a class life of 20 years.[50]

The ADR class life to be used in determining the property's qualification under the transition rule and its applicable placement in service date is, with one exception, the ADR class life prescribed in Rev. Proc. 83-35. The sole exception is that computer-based telephone central office switching equipment described in revised §168(e)(3)(B)(iii) is treated as having 6-year ADR class life. Act §203(b)(2)(C)(i). Thus, such equipment does not qualify for transition rule relief for purposes of the revised ACRS.

Note: The modifications made to the class lives of certain property for purposes of the alternative depreciation system in revised §168(g)(3)(B) do not apply for transition rule purposes. The transition rules [51] state that it is the class life of such property on January 1, 1986, that must be used.

The Conference Report provides that taxpayers who have difficulty identifying what property is placed in service under their accounting system because they regularly enter into contracts for large stocks of identical or similar items of property to be placed in service as needed may assume that the first items placed in service after December 31, 1986, are those under a binding pre-March 2, 1986, contract. A similar rule is to apply to self-constructed property.[52]

The Report further states that property incorporated into an equipped building or plant facility need not independently satisfy the placed-in-service requirement. Such incorporated property qualifies for transition relief as part of the equipped building or plant facility provided the building or facility is placed in service by the prescribed placement in service date.[53]

Observation: The equipped building, plant facility rule will also exempt incorporated property from the 7-year class life requirement. For example, assume the written plan for the equipped building includes a computer room and the computer equipment to be located in the room. Further assume that the building will satisfy the equipped building transition rule. The computer would appear to be part of the equipment that may be considered under the equipped building rule. However, a computer is assigned a 6-year ADR class life.[54] The Conference Report indicates that the computer will be considered placed in service along with the equipped building for purposes of the transition rule, and it further indicates, at page II-56 n. 1, that the 6-year class life is disregarded for purposes of the threshold 7-year class life requirement. Thus, the computer will be ineligible for transition relief.

c. Rehabilitation Credit Transition Rule

The 1986 TRA [55] makes a number of substantial modifications to the rehabilitation credit rules. Generally, the modifications are effective for rehabilitated property placed in service after 1986. Act §251(d)(1). However, the modified rules do not apply to property rehabilitated pursuant to a pre-March 2, 1986, binding written contract or to other rehabilitated property if certain other pre-March 2, 1986, developments occurred. Also, the rehabilitated property will not qualify for transition relief under the rehabilitation credit rules unless placed in service before January 1, 1994.[56]

Any property that qualifies under the rehabilitation credit transition rules is excluded from the revised ACRS.[57] Consequently, the 19-year recovery period (but limited to the straight-line rates under the rehabilitation credit rules) remains available for such property.

d. Sales and Leasebacks

Transition rules provide that, if a taxpayer acquires property from a person either in whose hands such property met one of the transition rules or who placed the property in service before 1987, and if the taxpayer leases back the property to that person not later than the earlier of (i) the applicable placement in service date (*i.e.*, December 31, 1988, or December 31, 1990) or (ii) the day that is 3 months after the property was placed in service, the property will be deemed to continue to qualify under the transition rule in the taxpayer's hands.[58]

The Conference Report provides that the rule applies where the taxpayer acquires property from a manufacturer, places the property in service by leasing it to the ultimate user, and subsequently engages in a sale-leaseback within 3 months after the property was originally placed in service under the initial lease. The Report further states that, if the facility otherwise qualifies as an equipped building and if a portion of the facility is sold and leased back in accordance with the sale and the leaseback requirements, both the leased and retained portion will continue to qualify under the equipped building transition rule.[59]

---

[46] *See* Rev. Proc. 83-35, 1983-1 C.B. 745, Asset Guideline Class 00.23.
[47] *Id.*, Asset Guideline Class 00.28.
[48] *Id.*, Asset Guideline Class 57.1.
[49] 1986 TRA, §203(b)(2)(C)(iii).
[50] 1986 TRA, §203(b)(2)(C)(ii).
[51] 1986 TRA, §203(B)(2)(C)(i).
[52] Conference Report, at II-53 and 54.
[53] *Id.*, at II-54.
[54] Rev. Proc. 83-35, *supra*, Asset Guideline Class 00.12.
[55] 1986 TRA, §251.
[56] 1986 TRA, §251(d).
[57] 1986 TRA, §203(a)(1) and 251(d)(2).
[58] 1986 TRA, §203(b)(3).
[59] Conference Report, at II-58 and 59.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

3. Pre-1987 Revised ACRS Election

a. General

A taxpayer may elect the earlier application of the revised ACRS as to any property placed in service after July 31, 1986 and before January 1, 1987.[60] The election must be made at the time and in the manner prescribed by the Service.[61] The Conference Report [62] instructs that the election is irrevocable and must be made on the first tax return for the taxable year in which the property is placed in service. The Report [63] further clarifies that the election may be made by the taxpayer on an asset-by-asset basis.

b. Planning Considerations

(i) Acceleration Benefit

Since the election can be made asset-by-asset, it should be considered for any post-July 31, 1986, 3, 5, or 10-year property under the pre-1986 TRA ACRS that will remain in the 3, 5 or 10-year category under the revised ACRS. As previously mentioned, the 200% declining balance method is used in depreciating such property under the revised ACRS; in contrast to the 150% declining balance method in the statutory accelerated percentages of the pre-1986 TRA ACRS. Thus, in such situations, the revised ACRS will yield greater depreciation deductions in the earlier years of the recovery period. If, however, such property would be reassigned to a longer revised ACRS period, the use of the revised ACRS would be detrimental from the standpoint of maximizing cost recovery deductions on a present value basis.

(ii) Alternative Minimum Tax Benefit

A second reason for considering the early election of the revised ACRS is that the alternative minimum tax treatment of property subject to the revised ACRS in the hands of non-corporate taxpayers may be more favorable. The 1986 TRA completely revised the alternative minimum tax for taxable years beginning after 1986.[64] For purposes of the post-1986 alternative minimum tax, depreciation on all property, including property subject to the revised ACRS early election, will be treated as an adjustment rather than a preference. *See* revised §56(a)(1). Because the minimum tax depreciation is computed using a less generous depreciation schedule, the adjustment may increase the alternative minimum tax in the years immediately after the property is placed in service. The adjustment in later years may, however, reduce the alternative minimum tax since the depreciation deduction computed for alternative minimum tax purposes will then exceed the deduction computed for regular tax purposes. In contrast, the pre-1986 TRA alternative minimum tax simply treats accelerated depreciation or cost recovery as a preference that is added to the alternative minimum tax income; no compensating adjustments are provided in later years that take into account the preference treatment of the accelerated deductions in the earlier years. *See* fomer §57(a)(2), (3), and (12). Moreover, a minimum tax credit may be provided by new §53 to the extent the accelerated depreciation adjustment under the revised alternative minimum tax results in the imposition of the alternative minimum tax. This credit is carried forward to ensuing years and applied to offset the regular tax when that tax exceeds alternative minimum tax liability.

The election is not advisable for alternative minimum tax purposes if the property is not leased property or if the property is owned by a corporate taxpayer. Under the pre-1986 TRA minimum tax rules,[65] accelerated depreciation on recovery property is treated as a tax preference only if leased by a noncorporate lessor. Under the post-1986 alternative minimum tax, depreciation on all property, whether or not leased and whether or not owned by a corporate taxpayer, is subject to the alternative minimum tax rules.

Although property subject to the election is governed by the revised alternative minimum tax rules taking effect after 1986, the interaction of the election with the minimum tax rules that remain effective through 1986 is less clear. As previously observed, the pre-1987 minimum tax system treats accelerated depreciation on "recovery property" leased by noncorporate lessors as a preference item. Since revised §168 completely eliminates the term "recovery property," the pre-1987 rules concerning the recovery property preference would not appear to reach property subject to the election in 1986. However, another preference provision in the pre-1987 system treats accelerated depreciation on §1245 property leased by a noncorporate lessor as a preference.[66] This provision presumably would extend to any §1245 property leased by a noncorporate lessor and subject to the election in 1986.

Comment: Noncorporate lessors who would have the right to appeal their cases to the Seventh Circuit would have "substantial authority"[67] for the position that leased property subject to the early election but not leased under a net lease is excluded as a preference for purposes of the pre-1987 alternative minimum tax. This is because in *Freesen v. Comr.*[68] the Seventh Circuit ruled that the §57(a)(3) preference is restricted to net lease property. Taxpayers residing outside the Seventh Circuit should exercise caution in relying on this decision since it appears to overlook statutory changes to §57(a)(3) made by the Tax Reform Act of 1976.[69]

(iii) Short-Year Effect

The effect of the revised ACRS early election for property placed in service during a short taxable year is unclear since the revised ACRS does not include a specific short taxable year proration rule. In contrast, pre-1986 TRA §168(f)(5) requires that the ACRS deduction for a short year be prorated based upon the number of months in the short year. For example, if a partnership is formed on December 1, 1986, and purchases and leases a computer costing $10,000 on that date, the $1,500 cost recovery

[60] 1986 TRA, §203(a)(1)(B).
[61] *Id.*
[62] Conference Report, at II-53.
[63] *Id.*, at II-39.
[64] *See* 1986 TRA, §701.

[65] §57(a)(12)(A), prior to amendment by the 1986 TRA.
[66] §57(a)(3), prior to amendment by the 1986 TRA.
[67] *See* Regs. §1.6661-3(b)(4)(ii).
[68] 86-2 USTC ¶9617 (7th Cir. 1986).
[69] P.L. 94-455, §301(c)(1)(C). The 1976 change eliminated the net lease reference although it retained for no apparent reason the definition of a net lease set forth in §57(c), which the Seventh Circuit relied on in reaching its decision in *Freesen.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

deduction (15% of $10,000 under the pre-1986 TRA §168(b)(1) table) must be reduced to $125 (1/12 of $1,500) since the partnership has only one month in its taxable year.

Under the revised ACRS, there is no statutory rule requiring this proration. In fact, since the computer in the foregoing example would be placed in service during the last three months of the taxable year — the inescapable consequence of a one-month taxable year — the mid-quarter convention technically applies unless regulations provide otherwise. Assuming that, under the revised ACRS, (i) a recovery period of "five years" means five taxable years, rather than a sixty-month period, (ii) the mid-quarter convention applies, and (iii) consequently, the one-month taxable year is split into four quarters, then the computer is considered placed in service in the first quarter of the one-month year of the partnership and the recovery deduction amounts to $3,500 ($10,000 × .40 × 7/8).

Comment: The Senate-passed version of the revised ACRS [70] contained a short-taxable year proration rule. The House bill, however, omitted any short-taxable year rule, and the Conference Report is silent on its omission of a short-year rule. The author understands that the omission was not inadvertent but was made in the belief that the Treasury Department could issue regulations to prescribe the computation of the depreciation deduction for a short year. As to property subject to the mid-quarter convention under the revised ACRS, regulatory authority clearly exists that would allow the mid-quarter convention to be overridden in a situation such as the short-taxable year.[71] Presumably, the regulations could require the use of the mid-month convention for a short-year. In the foregoing computer example, the depreciation deduction would be reduced to $166.66 using a mid-month convention ($10,000 × .40 × 1/24). However, if the mid-quarter convention does not apply to a short year because, for example, the short year consists of four months and at least 60 percent of the asset value is placed in service in the first month, there is no specific regulatory authority that would permit the use of a different convention. The use of a half-year convention would be required by statute in such case.[72]

Note: Another approach that might be taken in regulations is to provide that the reference to "years" in a recovery period as meaning full years, *i.e.*, twelve-month years. This approach would effectively require proration of the depreciation deduction based upon the total number of days in the year to 365 days or total number of months to twelve months. Assuming proration based upon the number of months in the short year to twelve months, then the $3,500 depreciation deduction for the computer computed using the mid-quarter convention would be reduced to $291.67.

II. Detailed Analysis of the Revised ACRS

A. Property Included

In general, all tangible, depreciable property, whether new or used, is subject to the revised ACRS if placed in service after 1986, unless a transition rule applies.[73] Intangible property, such as a patent, copyright, or contract right, is thus excluded. Moreover, leasehold improvements, whether owned by the lessor or lessee, are subject to the revised ACRS regardless of the length of the lease term.[74]

Foreign-use property, tax-exempt use property, and tax-exempt bond financed property are accounted for under the alternative depreciation system of revised §168(g).

B. Excluded Property

1. Certain Depreciation Methods

Revised §168(f)(1) excludes tangible property if (i) the taxpayer elects to exclude the property from the application of the system, and (ii) for the first taxable year for which a depreciation deduction would be allowable for such property in the hands of the taxpayer, the property is properly depreciated under the unit-of-production method or any other method of depreciation not expressed in a term of years (other than the retirement-replacement-betterment method or similar method). Under the unit-of-production method, an estimate is made of the total units which the asset is expected to produce. The cost of the asset, less estimated salvage value, is then divided by the total expected production to determine the depreciation per unit of output. This particular method has been most widely employed in the natural resources and transportation industries where units of production can readily be measured in, for example, tons of ore, barrels of oil, or miles logged. Another depreciation method not expressed in years is the machine hours or operating days method. This method can be applied to machinery that is expected to be useful for only a limited number of hours or days of operation.[75]

The income forecast method, under which the depreciation is computed based on the ratio of annual revenue generated by the property to total anticipated revenue, is another method that potentially could be used for tangible property, although its use has been more commonly associated with intangible property.

Observation: Prop. Regs. §1.168-4(b)(1)(i) takes the position that the election of a method not expressed in a term of years cannot be made unless the particular method was a recognized method within the industry for the type of property in question as of January 1, 1981. This provision was probably proposed in response to efforts by some taxpayers to elect a depreciation method not expressed a term of years to avoid the inflexible statutory ACRS recovery periods. Although the ACRS was generally beneficial, some industries found that the ACRS effectively lengthened their depreciation period. For example, video arcade games must be depreciated under the pre-1986 TRA ACRS over five years whereas, under prior law, the useful life and depreciation period for such assets might be only 24 months or less. Many taxpayers in that position sought to use an income forecast method although such method was not commonly used in the industry prior to January 1, 1981. The legislative history of the revised ACRS provides no indication of whether the position taken by the proposed

[70] §168(i)(11), H.R. 3838, §201, as passed by the Senate.
[71] Revised §168(d)(3)(A).
[72] *See* revised §168(d).
[73] *See* revised §168(a) and 1986 TRA, §§203 and 204, containing the effective date rules and transition rules.
[74] Revised §168(i)(8).
[75] *See, e.g.*, Rev. Rul. 56-652, 1956-2 C.B. 125.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

regulations is correct or not. Nor does legislative history describe when property will be considered "properly depreciated" under a depreciation method not expressed in a term of years. Given the statutory "properly depreciated" language, it would not be surprising if regulations adopted under the revised ACRS set forth a position similar to the position of the existing proposed regulations.

2. Public Utility Property

Revised §168(f)(2) (cross-referencing §167(l)(3)(A)) excludes property used by a public utility in connection with the furnishing of (i) electricity, (ii) gas or steam through pipeline, (iii) water, (iv) sewage disposal services, or (v) telephone services unless the utility accounts for depreciation for rate-making purposes under the normalization method. The normalization method is described in revised §168(i)(9). It requires the utility to calculate its tax expense for rate-making purposes using the same depreciation method and at least as long a depreciation period as used to compute its depreciation expense for rate-making purposes. Also, the taxes deferred by reason of revised §168 must be credited to a reserve account maintained by the utility. The effect of the normalization method is that the benefits of using the revised ACRS cannot be passed through to the utility's customers through reduced rates but must be accrued for the utility's benefit.

Note: Additional normalization rules are contained in the revised ACRS transition rules.[76] The effect of these additional rules is to preclude a utility from flowing through to customers the reduction that may be made in the utility's deferred tax reserves for depreciation to reflect the reduced corporate tax rates taking effect after 1986.

If the public utility property is excluded by reason of revised §168(f)(2), such property is depreciated for tax purposes in the same manner as it is depreciated for rate-making purposes.[77]

3. Films, Video, Tapes, Sound Recordings

Under revised §168(f)(3) and (4), any motion picture film or video tape and any sound recording described in §48(r)(5) is excluded property. Moreover, in the technical correction provisions of the 1986 TRA relating to depreciation,[78] §167(c) is amended to exclude motion films, video tapes, and sound recordings from eligibility for accelerated depreciation methods under §167(b). This latter legislation forecloses any additional debate that such films, tapes, and recordings qualify as tangible property for purposes of qualifying for accelerated depreciation under §167(b).[79]

4. Anti-Churning Rules

a. Introduction

The pre-1986 TRA ACRS sets forth detailed "anti-churning" rules in §168(e)(4) that are designed to prevent the conversion of property owned or used by a taxpayer or related person before 1981 into property that qualifies for the ACRS. The revised ACRS [80] retains these rules, incorporating them by reference.

Section 168(e)(4) sets forth three general categories of transactions that will cause pre-1981 property to be excluded from the pre-1986 TRA ACRS.

The first set of rules applies to "§1245-class property," which is generally tangible personal property or other tangible property used in a productive process (*see* former §§168(g)(3) and 1245(a)(3). Such property is excluded where acquired by the taxpayer after 1980 if:

(i) the property was owned or used at any time during 1980 by the taxpayer or related person;

(ii) the property is acquired from a person who owned that property at any time during 1980 and, as part of the transaction, the user of the property did not change;

(iii) the taxpayer leases the property to a person (or related party) who owned or used the property at any time during 1980; or

(iv) the property is acquired in a transaction as part of which the user of the property does change and the property is not recovery property in the hands of the person from which the property was so acquired by reason of (ii) or (iii), above.

The second set of rules applies to "§1250-class property", which is generally real property. Under these rules, property acquired by the taxpayer after 1980 is ineligible if:

(i) the taxpayer or a related person owned the property at any time during 1980;

(ii) the taxpayer leases the property to a person (or related party) who owned the property at any time in 1980; or

(iii) the taxpayer acquires the property in a non-recognition transaction described in §1031 (like-kind exchange), §1033 (involuntary conversion replacement property), §1038 (certain repossessed property), or §1039 (certain low-income housing replacement property) to the extent that the basis of the property is determined in whole or part by reference to the adjusted basis of other property owned by the taxpayer or a related person in 1980. The property acquired in such a transaction is excluded as recovery property only to the extent that its basis incorporates the adjusted basis of the 1980 property.

The third set of anti-churning rules in former §168(e)(4) applies to various corporate and partnership nonrecognition transactions. Excluded is any property received by the taxpayer after 1980 in a transfer under §332 (relating to subsidiary liquidations), §351 (transfers to controlled corporations), §361 (corporate reorganizations), §371(a) and §374(a) (certain bankruptcy reorganizations), §721 (transfers to partnerships), and §731 (partnership distributions) where the property had been placed in service by the transferor or distributor before 1981. Such property is excluded, however, only to the extent its basis is carried over to the taxpayer from the transferor.

[76] Act §203(e).
[77] Revised §168(i)(9)(C).
[78] 1986 TRA, §1809(d).
[79] For example, the Ninth Circuit in *Walt Disney Productions v. U.S.*, 549 F.2d 576 (9th Cir. 1977), ruled that motion picture films should be treated as tangible property for tax purposes. The Service took a decidedly contrary view; *see, e.g.*, TAM 7802004.

[80] Revised §168(F)(5)(A)(i).

Note: The related party rules for determining whether the transaction is a churning transaction involving §1245 or §1250 class-property are extremely broad. The rules of §267(b) and §707(b)(1) generally apply but substituting a 10% ownership requirement, for the higher ownership requirements in those provisions. In addition, commonly controlled businesses within the meaning of §52(a) and (b) are treated as related persons.[81] However, certain property obtained in complete liquidations or as to which a §338 election has been made may be excluded from the anti-churning provisions if the stock of the corporation involved was purchased after 1980. *See* former §168(e)(4)(E).

Finally, acquisitions by reason of death are excluded from the anti-churning rules.[82] Moreover, under regulations, §1245 class property which is acquired incidental to the acquisition of §1250 class property is to be governed by the anti-churning rules for §1250 class property.[83]

b. Application under Revised ACRS

As previously mentioned, the revised ACRS retains the foregoing rules.[84] Thus, for example, if a taxpayer transfers equipment that the taxpayer owned in 1980 to a partnership formed in 1987 of which he is a 25% partner, and the transfer was nontaxable under §721, the equipment will not be treated as recovery property subject to the pre-1986 TRA ACRS even if it is not treated as property subject to revised ACRS under the additional anti-churning provisions adopted for purposes of the revised ACRS.

The revised ACRS sets forth additional anti-churning rules, which are based upon the pre-1986 TRA ACRS anti-churning rules of §168(e)(4), to prevent the conversion of property owned before 1987 into property that would qualify for more favorable treatment under the revised ACRS. The revised ACRS provides for the use of all of the anti-churning rules described above but with a modification that the rules should be applied by substituting "1987" for "1981" and "1986" for "1980" each place those dates appear in former §168(e)(4). Thus, for example, a computer owned by a taxpayer in 1986 that is transferred to a partnership formed in 1987 of which the taxpayer is a 25% partner in a §721 transaction will generally not be subject to the revised ACRS. Depending upon whether the property was originally acquired by the taxpayer before 1981 or after 1980, the property will generally continue to be subject either to the useful life depreciation system, if acquired before 1981, or to the existing ACRS, if acquired by the taxpayer after 1980.

In applying the foregoing the anti-churning rules for purposes of the revised ACRS, two special rules apply. The first special rule provides that the pre-1987 anti-churning rules do not apply to any residential rental property or nonresidential real property.[85] Thus, for example, an office building acquired by a taxpayer after 1986 in one of the described churning transaction will be treated as nonresidential real property and thus subject to the extended recovery period and straight-line method prescribed in the revised ACRS for such property.

The second special rule, contained in revised §168(f)(5)(B)(ii), provides that the anti-churning exclusions do not apply to any property if, for the first full taxable year in which the property is placed in service (i) the amount allowable as a deduction under former §168 with respect to the property is greater than (ii) the amount allowable as a deduction under the revised ACRS for the full taxable year. In other words, if the revised ACRS would allow less favorable depreciation on the churned property than the pre-1986 TRA ACRS, the revised system applies.

Observation: Since residential rental property and nonresidential real property is excluded from the pre-1987 anti-churning provisions of the revised ACRS under the first special rule, the §1250 class property anti-churning rules will have diminished significance. However, they should not be disregarded entirely because, as previously mentioned, §1245 class property that is acquired incidental to acquisition of §1250 class property is governed by the §1250 class anti-churning provisions. Moreover, certain real property that would be treated as 19-year real property under the pre-1986 TRA ACRS may be treated as 15-year property under the revised ACRS. For example, a car wash building and related land improvements are treated as 15-year property under the revised ACRS[86] whereas the pre-1986 TRA ACRS treats such property as 19-year real property. For the first full year that the property would be in service under the revised ACRS—which would be the second year after acquisition since for the year of acquisition a convention would apply—the revised ACRS deduction would equal 9.5% of the original acquisition cost of the property. The maximum deduction under the pre-1986 TRA ACRS for 19-year real property for the first full year of service is 9.2% assuming that the property was placed in service in the last month of the taxable year within which acquired.[87] Thus, the pre-1986 TRA ACRS would continue to apply to the car wash building and related improvements assuming such property is placed in service after 1986 in a §1250 class property churning transaction.

C. Classification of Property

1. General

The revised ACRS sets forth six categories of property into which personal property and some real property will be classified, with a recovery period assigned to each category ranging from 3 through 20 years.[88] In addition, the revised ACRS sets forth two categories into which most real property will be classified — residential rental property and nonresidential real property.

The revised ACRS generally classifies personal and some real property according to its ADR class life.[89] The revised statute[90] further assigns certain types of personal

[81] Former §168(e)(4)(D).
[82] Former §168(e)(4)(H).
[83] Former §168(e)(4)(I).
[84] Revised §168(f)(5)(A)(i).
[85] Revised §168(f)(5)(B)(i).
[86] Rev. Proc. 83-35, *supra*, Asset Guideline Class 57.1, assigns a 20-year ADR class life to such property, which means that under revised §168(e)(1), such property is classified as 15-year property.
[87] *See* Rev. Proc. 86-6, 1986-1 C.B. 503, Table 1.
[88] *See* revised §168(c).
[89] *See* revised §168(e)(1).
[90] Revised §168(e)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

and real property to specific classes, assigns residential rental property (as defined in §167(j)(2)(B)) to the residential rental property class,[91] and assigns all other real property with an ADR class life of at least 27.5 years to the nonresidential real property class.[92]

Accordingly, the following steps might be used in classifying a particular item of property under the revised ACRS. First, examine the statute to determine whether the item is specifically assigned to a revised ACRS class. *See* §168(e)(3). For example, a race horse which is more than two years old at the time placed in service is treated as 3-year property under the statute.[93] Second, determine the ADR class life of the property. The mechanics of determining ADR class life is discussed in the next section.

Observation: Regardless of whether the statute specifically assigns an item to a particular revised ACRS class, the ADR class life should be ascertained. This is because the alternative depreciation system, which is used for such as purposes as determining the alternative minimum tax adjustment for depreciation for both corporate and noncorporate taxpayers after 1986 and for determining a corporate taxpayer's earnings and profits after 1986, generally employs the ADR class life in determining the amount of the depreciation deduction under that system.

One additional classification step that should be made is to determine whether an item of property constitutes tax-exempt use property, tax-exempt bond financed property, foreign use property, or Executive order import property. *See* §168(g)(1). If the item falls into any one of the foregoing categories, that item must be depreciated using the alternative depreciation system of revised §168(g).

2. ADR Classification Rules

For purposes of the ADR system, the Treasury Department grouped assets into more than 100 classes and assigned an "asset guideline period" to each class. For purposes of revised ACRS, this "asset guideline period" is the same as the ADR class life of the property. Generally, the grouping of assets into classes under the ADR was based on the business and industry within which the assets were used, and the assignment of class life to a class was based on the actual industry experience, treating the assets in a particular industry as having a composite life. For example, assets used to provide professional services (such as those offered by doctors, lawyers, and accountants) were grouped into a single class and given a class life of nine years.[94] Certain assets under the ADR, because of widespread usage, were grouped into general purpose classes and also assigned a class life. If a particular asset was described in one of the general purpose classes, the class life of that general purpose class was generally to be used in lieu of life applicable to the other assets used in that business. For example, typewriters, calculators, adding and accounting machines, copiers, and duplicating equipment were placed in one general purpose class with an asset guideline period of six years.[95]

The regulations under the ADR system provide the following additional classification rules. Regs. §167(a)-11(b)(4)(iii)(b) requires the placement of property into the ADR class for the activity in which the property is primarily used. Property must be classified according to its primary use even though the activity in which the property is primarily used is insubstantial in relation to all the taxpayer's activities. For example, if a large newspaper publisher owns the forest and pulp mill from which its paper is made, its logging equipment would be placed in one class with an ADR life of six years,[96] its pulp making equipment would be placed in a second category for pulp manufacturing assets with an ADR life of 13 years,[97] and its printing presses would be placed in a third category for printing assets with a class life of 11 years.[98] Although newspaper publishing may be the publisher's principal activity, the primary use of logging equipment is cutting timber and the primary use of the pulp manufacturing equipment is the manufacture of paper, each of which has a separate ADR class and class life.

Special ADR classification rules apply to leased property. Regs. §167(a)-11(e)(3)(iii) provides that a lessor of leased property should determine the ADR class of such property as if the property were owned by the lessee unless there was a specific ADR class in effect for lessors of such property. However, if the ADR class is based upon the type of property, such as buses or trucks, as distinguished from the activity in which used, the property must be classified without regard to the activity of the lessee. The fact that a lessee or contract is conditioned upon the inclusion of the leased property in an ADR class based upon the lessee's activity will not be binding upon the lessor for purposes of classifying the leased property under the foregoing provisions.

The regulations also provide [99] that property may not be reclassified for ADR purposes because of a change in primary use after the end of the taxable year in which the property is first placed in service. This includes a change in use that results in §1250 property becoming §1245 property. However, this classification rule may be overridden for purposes of the revised ACRS by regulations. Specifically, revised §168(i)(5) authorizes the issuance of regulations under which depreciation deductions will be recomputed for the year in which, and for succeeding years, the status of property changes in the taxpayer's hands.

A complete list of the ADR class lives may be found in Rev. Proc. 83-35.[100] The ADR class lives set forth therein are the lives to be used in determining whether property qualifies under the revised ACRS transition rules, except that computer-based telephone central office switching equipment is treated as having as a class life of six years.[101] These lives also are generally used in classifying property within a revised ACRS class and in determining the recovery period to be used under the alternative depreciation system. However, for purposes of the alternative depreci-

[91] Revised §168(e)(2)(A)
[92] Revised §168(e)(2)(B).
[93] Revised §168(e)(3)(A)(i).
[94] Rev. Proc. 83-35, *supra*, Asset Guideline Class 57.0.
[95] *Id.*, Asset Guideline Class 00.13.
[96] *Id.*, Asset Guideline Class 24.1.
[97] *Id.*, Asset Guideline Class 26.1.
[98] *Id.*, Asset Guideline Class 27.0.
[99] Regs. §1.167(a)-11(b)(4)(iii)(b).
[100] 1983-1 C.B. 745.
[101] 1986 TRA, §203(b)(2)(C).

ation system, certain property, such as a single purpose agricultural structure, which is assigned by statute to a revised ACRS class is also by statute assigned a specific class life for alternative depreciation system purposes. Thus, a single purpose agricultural structure is assigned to 7-year property class for purposes of the standard ACRS [102] and is assigned a 15-year class life for purposes of the alternative depreciation system.[103] Under Rev. Proc. 83-35, such a structure would have an ADR class life of 25 years.[104]

For purposes of the revised ACRS, the Treasury Department is authorized to establish an office to monitor and analyze actual experience with respect to all depreciable assets.[105] Except in the case of residential property or nonresidential real property, this office may prescribe a new class life for any property, may modify the life of any property assigned to a specific class, or may prescribe a class life for any property not having a class life under ADR. Any class life or assigned item prescribed or modified must reasonably reflect the anticipated useful life, and the anticipated declined in value over time, of the property to the industry or other group.[106] Any new or modified class life will be used in determining classification of such property under the revised ACRS and in applying the alternative depreciation system.[107]

The Conference Report provides the following guidelines to be used by the Treasury Department in classifying and reclassifying assets. First, the Report clarifies that the useful life means the economic life span of the property over all the users combined and not, as under prior law, the typical period over which a taxpayer holds the property. Second, the depreciation practices followed by taxpayers for book purposes with respect to the property is to be considered and the useful lives experienced by taxpayers based on their reports. Also to be considered is independent evidence of minimal useful life, such as the term for which new property is leased or financed, and independent evidence of decline in value of an asset over time, such as shown by resale price data. If resale price data is used to prescribe class lives, it should be adjusted to eliminate the effect of historical inflation.[108]

The Report further states that Treasury Department initial studies are expected to concentrate on property not having an ADR life. Additionally, rental clothing and scientific instruments (especially those used in connection with a computer) are to be studied to determine whether a change in class life is appropriate.[109]

Finally, the statute [110] prohibits the Treasury Department from reassigning property specifically assigned a recovery period into a longer class life if placed in service before January 1, 1992. Such property placed in service after December 31, 1991, and before July 1, 1992, may be prescribed a different class life if the Secretary notifies the Ways and Means Committee and Finance Committee of the proposed change at least six months before the date on which the change takes effect.[111] No prohibition exists on reassigning specifically assigned property to a shorter class life than the assigned life.[112]

3. Revised ACRS Categories

a. General

The revised ACRS sets forth the following categories of property and their recovery periods:[113]

Category	*Recovery Period*
3-year property	3 years
5-year property	5 years
7-year property	7 years
10-year property	10 years
15-year property	15 years
20-year property	20 years
Residential rental property	27.5 years
Non-residential real property	31.5 years

b. Classification Based on ADR Life

As previously mentioned, property is generally assigned to one of the 3 through 20-year classes based upon its ADR class life. The following table sets forth the general classification scheme:[114]

Revised ACRS Category	*ADR Class Life*
3-year property	4 years or less
5-year property	More than 4 years but less than 10
7-year property	10 or more years but less than 16
10-year property	16 or more years but less than 20
15-year property	20 or more years but less than 25
20-year property	25 or more years

In contrast to the pre-1986 TRA ACRS, the assignment of property to a particular revised ACRS recovery category does not depend upon whether the property is §1245 or §1250 property. However, under Rev. Proc. 83-35, whether property is §1245 or §1250 property may be relevant in determining which ADR life is assigned to that property. For example, §1245 assets used in marketing petroleum are assigned a 9-year ADR class life and, consequently, are 5-year property under the revised ACRS.[115] Section 1250 assets, including service station buildings, used in the marketing of petroleum and petroleum products are, in contrast, assigned a 20-year ADR class life and are, consequently, 15-year property under the revised ACRS.[116]

[102] *See* revised §168(e)(3)(C)(ii).
[103] *See* revised §168(g)(3)(B).
[104] Rev. Proc. 83-35, *supra,* Asset Guideline Class 01.3.
[105] Revised §168(i)(1)(B).
[106] *Id.*
[107] Revised §168(i)(1)(C).
[108] Conference Report, at II-42.
[109] *Id.*
[110] §168(i)(1)(D).
[111] Conference Report, *supra,* at II-42.
[112] Revised §168(i)(1)(D).
[113] Revised §168(c).
[114] Revised §168(e)(1).
[115] Rev. Proc. 83-35, *supra,* Asset Guideline Class 57.0.
[116] *Id.*, Asset Guideline Class 57.1.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Set forth below is a representative sampling of assets included in the 3 through 20-year revised ACRS categories based upon Rev. Proc. 83-35; the list excludes any properties specifically assigned to a revised ACRS category by statute:

3-year Property: Truck tractors for over-the-road use (4-year ADR life); breeding hogs (3-year ADR life); special handling devices for food and beverage manufacture (4-year ADR life); special tools and devices for rubber product manufacture (4-year ADR life); special tools for fabricated metal product manufacture (3-year ADR life); and special tools for motor vehicle manufacture (3-year ADR life).

5-year Property: Data handling equipment, such as typewriters, calculators, adding and accounting machines, copiers and duplicating equipment (6-year ADR life); airplanes, except those used in commercial or contract carrying of passengers or freight, and all helicopters (6-year ADR life); buses (9-year ADR life); heavy general purpose trucks (6-year ADR life); trailers and trailer-mounted containers (6-year ADR life); breeding or dairy cattle (7-year ADR life); breeding sheep and goats (5-year ADR life); oil and gas well drilling assets (6-year ADR life); assets used in the manufacture of chemicals and allied products (9.5-year ADR life); and assets used in distributive trades and services, including wholesale and retail trade and personal and professional services (9-year ADR life).

7-year Property: Office furniture, fixtures, and equipment, such as desks, files, and safes (10-year ADR life); rail cars and locomotives, except those owned by railroad transportation companies (15-year ADR life); agriculture machinery and equipment (10-year ADR life); cotton ginning assets (12-year ADR life); mining assets (10-year ADR life); oil and natural gas exploration assets (14-year ADR life); assets used in the printing, publishing, and allied industries (11-year ADR life); assets used for the manufacture of rubber products, other than special tools (14-year ADR life); assets used to manufacture aerospace products (10-year ADR life); assets used to provide entertainment services, such as bowling, billiard and pool, theater, concert halls, and miniature golf courses (10-year ADR life); and assets used in theme and amusement parks (12.5-year ADR life).

10-year Property: Vessels, barges, tugs, and similar water transportation equipment except those used in marine construction (18-year ADR life); petroleum refining assets (16-year ADR life); and assets used to produce sugar and sugar products and vegetable oil and vegetable oil products (18-year ADR life).

15-year Property: Land improvements, except those explicitly included in any other class and except buildings and structural components (20-year ADR life); cement manufacture assets (20-year ADR life); and liquefied natural gas plants (22-year ADR life).

20-year Property: Farm buildings, but excluding special purpose structures specifically assigned by the revised ACRS (25-year ADR life); and water utility assets used in the gathering, treatment, and commercial distribution of water (50-year ADR life).

c. Statutory Assignments

Revised §168(e)(3) assigns the following property to the specific revised ACRS categories:

3-year Property: Any race horse that is more than two years old at the time it is placed in service and any other horse that is more than 12 years old at the time it is placed in service.

Note: The pre-1986 TRA ACRS proposed regulations, Prop. Regs. §1.168-3(c)(1)(iii), require that a horse's age be determined based upon its actual birth date. The practice in the racing industry of aging a horse by one year each January 1 is thus not followed. Since race horses are not assigned an ADR class life, any race horse less than two-years old when placed in service will be treated as 7-year property under §168(e)(3)(C)(iii), in contrast to the 5-year classification under the pre-1986 TRA ACRS, unless the Treasury Department assigns race horses a class life of less than 10 years as it is authorized to do by revised §168(i)(1). A breeding or a work horse that is 12 years old or less at the time it is placed in service will in any event be treated as 7-year property because of the existing ADR class life of 10 years for breeding and work horses.

5-year Property: (i) Any automobile or light general purpose truck, (ii) any semi-conductor manufacturing equipment, (iii) any computer-based telephone central office switching equipment, (iv) any qualified technological equipment, (v) any property used in connection with research and experimentation,[117] or (vi) any property described in §48(l)(3)(A)(viii), (3)(A)(ix), or (4) (generally certain types of alternative energy equipment) or, any property which is described in §48(l)(15) (biomass property) if it is a qualifying small power production facility under a specified provision of Federal Power Act.[118]

Note: The revised ACRS thus reclassifies as 5-year property cars and light trucks and research and experimentation property that under the pre-1986 TRA ACRS is treated as 3-year property. To reflect the reclassification of cars and light trucks, the maximum cost recovery caps in §280F(a), dealing with luxury automobiles, are reduced.

Comment: Technically, any building or structural components used in connection with research and experimentation qualifies as 5-year under the revised ACRS since revised §168(e)(3)(B) refers to "any property" in assigning research and experimentation property to the 5-year category; no exclusion is made for §1250 property. It should also be noted that Prop. Regs. §1.168-3(c)(1)(ii) adopts a "predominate use" (more than 50% use) test in determining whether property used in connection with research and experimentation qualifies as 3-year property for purposes of the pre-1986 TRA ACRS. The application of a "predominate use" test for ACRS purposes is open to question because case law exists under the investment credit provisions that holds property is used "in connection with" if used for a substantial amount of time in the described activity.[119]

---

[117] "Research and experimentation" has the same meaning as "research and experimental" in §174. Revised §168(i)(11).

[118] 16 U.S.C. 796(17)(C), as in effect on September 1, 1986.

[119] *See Northville Dock Corporation v. Comr.*, 52 T.C. 68 (1969), aff'd *per curiam*, 427 F.2d 164 (2d Cir. 1970).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Observation: Qualified technological equipment is defined as (i) any computer or peripheral equipment, (ii) any high technology telephone station equipment installed on the customer's premises, and (iii) any high technology medical equipment.[120] A computer is defined as a programmable electronically activated device that (i) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and (ii) consists of a central processing unit containing extensive storage logic, arithmetic, and control capabilities. Related peripheral equipment means any auxiliary machine (whether on-line or off-line) that is designed to be placed under the control of the central processing unit of a computer. Excluded from the term "computer or peripheral equipment" is (i) any equipment that is integral part of other property that is not a computer, (ii) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment and similar equipment, and (iii) equipment of a kind used primarily for the amusement or entertainment of the user.[121] The statute [122] defines "high technology medical equipment" as any electronic, electromechanical, or computer-based high technology equipment used in screening, monitoring, observation, diagnosis, or treatment of patients in a laboratory, medical, or hospital environment.

Comment: Neither the statute nor legislative history defines what is meant by high technology telephone station equipment installed on the customer's premises. However, the same terminology is incorporated in the tax-exempt entity leasing rules of the pre-1986 TRA ACRS.[123] The temporary regulations under those provisions [124] defines such equipment as including only tangible personal property described in Rev. Proc. 83-35, Asset Guideline Class 48.13. This class includes station apparatus and connections such as teletypewriters, telephones, booths, private exchanges, and comparable equipment. However, to be treated as "high technology" equipment, it must have high technology content which, because of such content, can reasonably be expected to become obsolete before the expiration of its physical useful life. The temporary regulations state, as an example, that telephone booths and telephones including only a standard dialing feature are not high technology equipment. However, telephones with features such as abbreviated dialing programs, automatic callbacks, or conference call features may qualify as high technology equipment. It is not entirely clear whether the high technology telephone equipment definition applies only to such equipment that is owned by a taxpayer providing commercial and contract telephonic services. On the one hand, the statutes (both pre-1986 TRA §168(j)(5)(C)(i)(II) and revised §168(i)(2)(A)(ii)), speak in terms of installation on the customer's premises, which implies that a customer must be involved. Moreover, Asset Guideline Class 48.13 in Rev. Proc. 83-35 is a category specifically applicable to providers of commercial and contract telephonic services. On the other hand, the high technology telephone equipment definition originated in the tax-exempt entity leasing rules, and these rules would generally apply only where the property was leased or provided under a services contract. Since the high technology telephone equipment definition applies for all classification purposes under the revised ACRS, the definition might conceivably be extended to include such equipment owned by a taxpayer for its own business use. If not so extended, however, taxpayer-owned and used high-tech phone equipment will be treated as 7-year property because of the ADR life of 10 years assigned to such property.[125]

7-year Property: (i) any railroad track, (ii) any single-purpose agricultural or horticultural structure, as defined in §48(p), and (iii) any property not having a class life and that is not otherwise classified.

15-year Property: (i) any municipal wastewater treatment plant, and (ii) any telephone distribution plant and comparable equipment used for 2-way exchange of voice and data communications.

20-year Property: Any municipal sewers.

4. Real Property

Revised §168(e)(2) defines the terms "residential rental property" and "nonresidential real property." "Residential rental property" is effectively defined, by reference to §167(j)(2)(B), as a building or structure with respect to which at least 80% of the gross rental income is rental income from dwelling units.[126] For purposes of the §167(j)(2)(B) definition, if the taxpayer occupies any portion of a building or structure, the gross rental income from the building or structure includes the rental value of the portion so occupied. A "dwelling unit" is generally a house or apartment used to provide living accommodations but excludes a unit in a hotel, motel, or other establishment where more than one-half of the units are used on a transient basis.[127]

"Nonresidential real property" is defined as §1250 property that is not (i) residential property or (ii) property with a class life of less than 27.5 years. For example, since a hotel is excluded from the definition of "residential rental property" and has no ADR class life, it is nonresidential real property and, thus, must be depreciated over a 31.5-year recovery period. In contrast, since amusement park structures are assigned a 12.5-year ADR class life, such structures are excluded as nonresidential real property since the ADR class life is less than 27.5 years; such structures are properly assigned to the 7-year property class under the revised ACRS. The treatment accorded theme and amusement park structures under the revised ACRS is more favorable than the pre-1986 TRA ACRS, which assigns such property to the 10-year recovery period. *See* former §168(c)(2)(C)(ii).

Note: A special rule in the pre-1986 TRA ACRS [128] effectively provides that a building and structural components will not be treated as 10-year property if the building

[120] Revised §168(i)(2)(A).
[121] Revised §168(i)(2)(B).
[122] Revised §168(i)(2)(C).
[123] Former §168(j)(5)(C)(i)(I).
[124] Temp. Regs. §1.168(j)-1T, Q&A-15.

[125] Rev. Proc. 83-35, *supra*, Asset Guideline Class 00.11, listing communications equipment under the office, furniture, fixtures, and equipment heading.
[126] Revised §168(e)(2)(A), incorporating by reference §167(j)(2)(B).
[127] *Id.*, incorporating by reference §167(k)(3)(C).
[128] Former §168(c)(2)(G).

is converted to a theme or amusement park structure after it was originally placed in service. The effect of this rule is to clarify that the building will be treated as 19-year real property eligible for the rehabilitation investment credit. This special rule is not retained in the revised ACRS. Moreover, the rehabilitation credit, which was also extensively modified by the 1986 TRA,[129] specifically provides that real property having a class life of more than 12.5 years may qualify for a rehabilitation credit,[130] in addition to specifying that nonresidential real property and residential rental property may qualify for the credit.[131] The legislative history is silent as to whether the omission of the special rule from revised §168 and the specification of a more than 12.5 year ADR class life for real property in revised §48(g) was intended to eliminate the rehabilitation credit for a building converted into an amusement park structure.

Observation: The pre-1986 TRA ACRS rules[132] that treated a manufactured home that is §1250 class property and used as a dwelling unit as 10-year property are deleted from the revised ACRS. Thus, manufactured homes are treated as residential rental property under the revised system.

Note: In contrast to the pre-1986 TRA ACRS treatment of low-income housing, which assigns such property to the 15-year class using 200% declining balance rates, the revised ACRS classifies low-income housing as residential rental property. Thus, the cost of such property is recovered over a 27.5 year life. Moreover, the low-income housing rehabilitation expenditure rules of §167(k), which permit 60-month amortization of low-income housing rehabilitation expenditures up to certain limits, are allowed to expire as scheduled on January 1, 1987. A low-income housing credit in new §42 of the Code may be available for low-income housing after 1986. For an analysis of this credit, *see* Chapter 12.

D. Computation of Depreciation Allowance

1. General

Section 168(a) provides that the depreciation deduction for tangible property under the revised ACRS must be determined by using (i) the applicable depreciation method, (ii) the applicable recovery period, and (iii) the applicable convention. In contrast to the pre-1986 TRA ACRS, which either prescribes statutory percentages or requires the Service to prescribe accelerated and straight-line percentages, the computation of the deduction is left to the taxpayer.

The applicable recovery period was described in the preceding section concerning the classification of property under the revised ACRS. The applicable depreciation method and the applicable convention, both of which may vary depending upon the applicable recovery period, are described below.

2. Applicable Depreciation Method

For property in the revised ACRS 3, 5, 7, and 10-year categories, the applicable depreciation method is the 200% declining balance method with a switch to the straight-line method for the first taxable year for which use of the straight-line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance. *See* revised §168(b)(1), (2), (3), and (e)(1) and (2).

For 15-year and 20-year property, the 150% declining balance method is used in lieu of the 200% declining balance method but the same switch to the straight-line method is made when the straight-line method will yield a larger deduction. *See* revised §168(b)(2).

Under the declining balance method, the rate remains the same each year, but it is applied only to the basis remaining each year after subtracting all depreciation allowances for previous years. As the remaining basis decreases, so do the annual depreciation allowances. For example, assuming (i) property is placed in service on the first day of a full taxable year, (ii) the recovery period is five years, and (iii) no convention applies, the 200% declining balance method translates into a 40% rate ($1/5 \times 200\% = .40$). If an asset costs $100, the 40% declining balance rate yields a $40 deduction for the first year ($\$100 \times 40\% = \$40$), and a $24 deduction for the second year (($\$100 - 40) \times 40\% = \$24$). For the third year, the 40% rate yields a $14.40 depreciation deduction. For the fourth and fifth years, when the adjusted basis has now been reduced to $21.60, a switch to the straight-line method for the remaining two-year period should be made because the $10.80 depreciation deduction ($\$21.60/2 = \$10.80$) exceeds the $8.64 deduction that would be applied by applying the 40% declining balance rate to the $21.80 adjusted basis remaining at the beginning of the fourth year.

The taxpayer may elect the use of the straight-line method in lieu of the use of the 200% declining balance or 150% declining balance method, as the case may be.[133] This straight-line election may be made with respect to one or more classes of property for any taxable year and, once made with respect to a class, applies to all property in that class placed in service during that taxable year. The election is irrevocable once made.[134]

For nonresidential real property and residential rental property, the straight-line method is required.[135]

As under the pre-1986 TRA ACRS, salvage value is treated as zero in determining the amount of depreciation deduction under any of the foregoing methods. Revised §168(b)(4).

3. Applicable Convention

In general, the applicable convention is the half-year convention.[136] The applicable convention for nonresidential real property and residential rental property is the mid-month convention.[137]

The half-year convention is a convention that treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or

[129] 1986 TRA, §251.
[130] Revised §48(g)(2)(A)(i)(III).
[131] Revised §48(g)(2)(A)(i)(I) and (II).
[132] Former §168(h)(3) and (g)(7).
[133] Revised §168(b)(3)(C) and (5).
[134] Revised §168(b)(5).
[135] Revised §168(b)(3)(A) and (B).
[136] Revised §168(d)(1).
[137] Revised §168(d)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

disposed of) on the mid-point of such taxable year.[138] The mid-month convention is a convention that treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid point of such month.[139]

The half-year convention under the revised ACRS is generally the same as the half-year convention used under the pre-1986 TRA ACRS to compute straight-line deductions when the straight-line method is employed for 3, 5, 10 or 15-year recovery property. (*Cf.*, former §168(b)(3)(B)(iii) and Prop. Regs. §1.168-2(c)(4)(i), which sets forth optional straight-line percentages employing the half-year convention.) However, in a change from the pre-1986 TRA ACRS, a half-year's worth of depreciation is allowed under the revised ACRS if property is disposed of during its recovery period; under the pre-1986 TRA ACRS, a recovery deduction in the year of disposition is generally not allowed.[140]

The mid-month convention under the revised ACRS is identical to the mid-month convention employed under the pre-1986 TRA ACRS for 19-year real property.[141]

The revised ACRS provides for a new mid-quarter convention where substantial property is placed in service during the last three months of a taxable year.[142] The mid-quarter convention applies to all property placed in service during the taxable year, but excluding nonresidential real property and residential rental property, if during the taxable year (i) the aggregate bases to which the revised ACRS applies and which are placed in service during the last three months of the taxable year exceed (ii) 40% of the aggregate bases of property to which the revised ACRS applies.[143] For purposes of applying the foregoing 40% test, residential rental property and nonresidential real property are not taken into account.[144] However, for taxable years in which property is placed in service subject to both the pre-1986 TRA ACRS and to the revised ACRS, the 40% test is made taking into account all property except nonresidential real property and residential rental property. The mid-quarter convention, however, applies only to the property subject to the revised ACRS.[145] The Conference Report instructs that if a taxpayer is a member of an affiliated group, as defined under §1504 but without regard to the corporations excluded by §1504(b), all members are treated as one taxpayer for purposes of the 40% test.[146]

Note: The statute provides for the application of the mid-quarter convention if the 40% test is met "except as provided in regulations."[147] The legislative history gives no indication of when the mid-quarter convention would not apply. As suggested in the discussion of the early election of the revised ACRS, one situation where regulations might require use of a different convention, such as the mid-month convention, is in a short-taxable year. *See* I, E, b, (3), *supra.*

The mid-quarter convention is defined in revised §168(d)(4)(C) as a convention that treats all property placed in service during any quarter of a taxable year (or disposed of during any quarter of a taxable year) as placed in service (or disposed of) on the mid-point of such quarter. For example, if property is placed in service during the first quarter of a full taxable year, 10.5 months' worth of depreciation is allowed with respect to such property. If placed in service during the second quarter of such year, 7.5 months' worth of depreciation would be allowed. If placed in service in the third quarter, 4.5 months' worth of depreciation would be allowed. Finally, if placed in service during the last quarter, 1.5 months' worth of depreciation would be allowed.

Observation: As a rule of thumb, the application of the mid-quarter convention will be avoided if the taxpayer limits fourth quarter acquisitions to 66.66% of the aggregate bases of assets acquired during the first three quarters of the taxable year, disregarding residential rental property and nonresidential real property acquisitions during that year. For example, if assets acquired during the first three quarters have an aggregate basis of $100, an additional $66.66 of assets may be placed in service during the fourth quarter. The $66.66 of fourth quarter assets constitutes 40% of the $166.66 assets acquired for the full taxable year (66.66/166.66 = .39999). On the other hand, where first quarter acquisitions have been heavy, a taxpayer may find it advantageous to place in service sufficient assets during the fourth quarter to require the application of the mid-quarter convention. In such case, the placement in service during the fourth quarter of 67% of the aggregate basis of assets placed in service during the first three quarters will cause the mid-quarter convention to apply.

4. Examples

The following examples illustrate the computation of the depreciation deduction for a particular asset in the 3-year, 5-year, and 7-year revised ACRS categories using, alternatively, the half-year convention and the mid-quarter convention.

a. 3-Year Property Examples

A $100 asset in the 3-year class and subject to the half-year convention will yield the following recovery deductions over a 4-year period:

Year One:	$ 33.33
Year Two:	$ 44.44
Year Three:	$ 14.82
Year Four:	$ 7.41
Total:	$100.00

Note: A switch to the straight-line method is made in Year Three. In Year Three the remaining adjusted basis is $22.23. Since there are still three half-years left in the depreciation period, consisting of the two halfs of Year Three and the first half of Year Four, the straight-line deduction is determined by dividing $22.23 by 3 and multiplying by 2 to obtain the deduction for Year Four.

[138] Revised §168(d)(4)(A).
[139] Revised §168(d)(4)(B).
[140] Compare former §168(d)(2)(B) with revised §168(d)(4)(A).
[141] Compare former §168(b)(2) with revised §168(d)(4)(B)..
[142] Revised §168(d)(3).
[143] *Id.*
[144] Revised §168(d)(3)(B); Senate Report at 102.
[145] Conference Report at II-47.
[146] *Id.*
[147] Revised §168(d)(3)(A).

If, instead, the mid-quarter convention is used and the $100 asset is placed in service during the first quarter of the taxable year, the depreciation deductions are as follows:

Year One:	$ 58.33
Year Two:	$ 27.78
Year Three:	$ 12.35
Year Four:	$ 1.54
Total:	$100.00

b. 5-Year Property Examples

Assuming the use of the half-year convention for a $100 item of property in the 5-year class, the revised ACRS deductions for years one through six are as follows:

Year One:	$ 20.00
Year Two:	$ 32.00
Year Three:	$ 19.20
Year Four:	$ 11.52
Year Five:	$ 11.52
Year Six:	$ 5.76
Total:	$100.00

Note: The foregoing example is taken from the Senate Finance Committee Report.[148] The Report further provides that if the asset were disposed of in Year Two, the ACRS deduction for that year would be $16.[149]

Assuming the use of the mid-quarter convention for the $100 item and the placement in service of the property during the first quarter of the taxable year, the depreciation deductions for years one through six are be as follows:

Year One:	$ 35.00
Year Two:	$ 26.00
Year Three:	$ 15.60
Year Four:	$ 11.01
Year Five:	$ 11.01
Year Six:	$ 1.38
Total:	$100.00

Note: The foregoing example appears in the Conference Report.[150]

c. 7-Year Examples

Assuming the use of the half-year convention for a $100 item of 7-year property, the depreciation deductions for years one through eight are as follows:

Year One:	$ 14.29
Year Two:	$ 24.49
Year Three:	$ 17.49
Year Four:	$ 12.49
Year Five:	$ 8.93
Year Six:	$ 8.93
Year Seven:	$ 8.93
Year Eight:	$ 4.45
Total:	$100.00

Assuming the use of the mid-quarter convention and the placement in service of the $100 item of 7-year property in the fourth quarter of a taxable year, the depreciation deductions for years one through eight are as follows:

Year One:	$ 3.57
Year Two:	$ 27.55
Year Three:	$ 19.68
Year Four:	$ 14.06
Year Five:	$ 11.24
Year Six:	$ 11.24
Year Seven:	$ 11.25
Year Eight:	$ 1.41
Total:	$100.00

d. Real Property Examples

Assuming that residential rental property is placed in service in the first month of a full taxable year and that its adjusted basis is $10,000, the straight-line deduction for year one applying the mid-month convention will be $348.48 ([$10,000 ÷ 27.5] × 23/24). For years two through 27, the depreciation deduction will equal $363.64 ($10,000 ÷ 27.5). The deduction for the 28th year will equal $196.88.

If nonresidential real property with an adjusted basis of $10,000 is placed in service in the first month of a full taxable year, the recovery deduction for the first year applying the mid-month convention will be $304.23. For years two through 31, the straight-line recovery deduction will equal $317.46 in each year. The depreciation deduction for year 32 will equal $171.97.

5. Use of Adjusted Basis

The adjusted basis of property is used in determining depreciation deductions under the revised ACRS. The pre-1986 TRA ACRS, in contrast, uses the "unadjusted" basis to determine cost recovery deductions.[151] Consequently, the Service is authorized under former §168(d)(1)(B)(ii) to issue regulations providing for a variation in the computation of depreciation deductions for any taxable year, and succeeding taxable years, where basis must be redetermined, such as where basis increases in a subsequent year because a contingent payment is made on the original purchase price. Prop. Regs. §1.168-2(d)(3) effectively provides that where basis is redetermined in a subsequent year, the basis increase or decrease is taken into account over the remaining recovery period through increased or decreased recovery deductions, as the case may be. Since the revised ACRS employs the adjusted basis, the same principles should apply without the need for regulatory authorization.

6. Short Taxable Years

As previously discussed in the analysis of the transition rules, the requirement that a depreciation deduction be prorated based upon the ratio of the number of months in the short year to twelve months is omitted from revised §168. As discussed, the omission apparently was not inadvertent but was made in the belief that the Treasury Department could issue regulations to prescribe the compu-

[148] Senate Report at 101.
[149] *Id.*
[150] Conference Report at II-47.
[151] *See* former §168(b)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tation of the depreciation deduction for a short year. Precisely how regulations will deal with the short year depreciation computation is unclear. The regulations might take the position that "years" in the recovery period for purposes of the revised ACRS means full years rather than taxable years. Thus, for example, a recovery period of five years means five 12-month years or five 365-day years, and not five taxable years. Thus, in any short taxable year, a proration of the depreciation deduction would be required based upon the number of days or months in the taxpayer's short year to 365 days (or twelve months, depending upon whether the regulations define the recovery period "year" in terms of days or months).

Example: Assume that the regulations define a recovery period "year" to consist of twelve months and to require a proration of a depreciation deduction where the taxpayer has a short taxable year during the recovery period based upon the number of months in the short year to 12 months. Further assume that a corporate taxpayer who places in service a $100 item in the 5-year class in Year One and properly applies the half-year convention to compute the depreciation deduction in Year One. If, in Year Two, the taxpayer has a short taxable year of three months because, for example, it joins in filing a consolidated return, its recovery deduction for Year Two would be prorated based upon the ratio of three months to twelve months. The taxpayer's revised ACRS deductions for Years One and Two would therefore be as follows:

Year One:	$20.00
Year Two:	$ 8.00

Since, because of the application of the half-year convention in year One and the short-taxable year of three months in Year Two, only 9 months of the 60-month recovery period has been taken into account, the remaining recovery period would consist of 51 months or 4 years and 3 months. Continuing to apply the 200% declining balance method with a switch to the straight-line when appropriate to maximize the depreciation deduction, the remaining cost of the asset would be recovered as follows:

Year Three:	$ 28.80
Year Four:	$ 17.28
Year Five:	$ 11.52
Year Six:	$ 11.52
Year Seven:	$ 2.88

E. Commencement and Termination of Depreciation

1. Placement in Service

As implied in the definitions of the half-year, mid-quarter, and mid-month conventions,[152] depreciation under the revised ACRS commences in the year that the property is placed in service. The concept of placement in service is important not only because it establishes when depreciation begins, but because it also applies in determining whether property is subject to the revised ACRS under the transition rules, as previously discussed. The concept is also important under the anti-churning provisions of the revised ACRS.

The statute does not provide a definition of placement in service. However, Prop. Regs. §1.168-2(l)(2) defines placement in service for purposes of the pre-1986 TRA ACRS in a manner substantially similar to the definition used for the prior depreciation systems and the investment credit. The proposed regulations state that "placed in service" means the time that property is first placed by the taxpayer in a condition or state of readiness and availability for a specifically assigned function, whether for use in a trade or business, for production of income, in a tax-exempt activity, or in a personal activity.

Comment: The Senate Finance Committee Report [153] indicates that the placement in service concept should be changed for purposes of the revised ACRS insofar as personal use is concerned. The Report states that it is intended that property placed in service prior to 1987 for personal purposes and converted to business or income-producing use after 1986 should be treated as originally placed in service when first placed in service for business or income-producing use. The report further states that such converted property will not be subject to the anti-churning rules of the revised ACRS. Initially, it should be noted that the anti-churning rules do not technically apply in any event since those rules require an acquisition by the taxpayer after 1980, or 1986, as the case may be, of property owned (or used, if personal property) in 1980 or 1986, as the case may be — the implication of this being that the taxpayer regains possession of property previously relinquished. The rules do not directly address the situation where a taxpayer continues to own into 1981 (or 1987) property held in 1980 (or 1986) and the use of that property changes. More significantly, the statute does not make any mention of a special placement in service rule for revised ACRS purposes involving the conversion of personal use property, nor does the revised ACRS generally authorize the issuance of legislative regulations. Whether interpretative regulations can change the longstanding definition of placement in service based solely on the Senate Finance Committee Report [154] is uncertain. Assuming that such a change in the definition is adopted and upheld, a pre-1987 owned personal residence that is converted to rental use after 1986 would be treated as 27.5 year residential rental property under the revised ACRS even though, absent such change, the residence would be treated under either the pre-1981 useful life system or as recovery property, depending upon whether the residence was acquired before 1981 or after 1980.

2. Retirements; Dispositions

a. General

As previously mentioned, the half-year and mid-quarter conventions set forth in revised §168(d)(4) allow a depreciation deduction to be claimed in the year that property in the 3 through 20-year categories is disposed of. This is in contrast to the pre-1986 TRA ACRS, which does not allow

[152] *See* revised §168(d)(4).

[153] Senate Report at 108.

[154] The Conference Report, at II-54, simply states that converted personal use property is exempt from the anti-churning provisions.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

a recovery deduction in the year of disposition for personal property. As under the pre-1986 TRA ACRS, residential rental property and non-residential real property are provided a depreciation deduction under the mid-month convention in the year of disposition based upon the number of months, plus a half month for the month of disposition, in the year such property is disposed of.

In another change from the pre-1986 TRA ACRS, the rule mandating the treatment of a retirement as a disposition is stricken from the revised ACRS.[155] Thus, the rule of the useful life and ADR systems of depreciation that defers recognition of gain if a retirement is "normal" or "ordinary" (*i.e.*, due to routine causes) is apparently restored. *See generally, e.g.*, Regs. §1.167(a)-11(d)(3). Thus, only if an asset subject to the revised ACRS is sold, abandoned, or otherwise disposed of in a taxable transaction will gain or loss be required to be recognized.

The character of any gain on the disposition of property subject to the revised ACRS depends upon whether it is §1245 or §1250 property. In general, property in the 3 through 20-year classes will be §1245 property, and gain will be recaptured as ordinary income to the extent depreciation was previously allowed or allowable. However, some items in these categories may constitute §1250 property, in which case only accelerated depreciation in excess of what would be allowed using the straight line method is subject to recapture as ordinary income. Assuming, however, that the elimination of the capital gains/ordinary income differential, which will be fully effective in 1988, remains in the Code indefinitely, the treatment of gain as ordinary rather than as capital under the recapture rules will have reduced significance.

Residential rental property and non-residential real property are not subject to the recapture rules since such property is §1250 property and the straight-line method is employed in computing the depreciation allowances for such property. Thus, there is no accelerated element that would be subject to recapture under §1250.

b. General Asset Accounts

Section 168(i)(4) provides that, under regulations, a taxpayer may maintain one or more general asset accounts for purposes of the revised ACRS. Except as provided in the regulations, all proceeds realized on any disposition of property in a general asset account must be included in income as ordinary income. The foregoing rule is essentially the same as the mass asset accounting rule of the pre-1986 TRA ACRS.[156]

The Senate Finance Committee Report indicates that, because of the repeal of the investment credit, the types of assets that can be included in general asset accounts should be greatly expanded. The Report observes that proposed regulations limit the ability to establish mass asset accounts under prior law in part from a concern about the mechanics of recapturing investment credits on the disposition of property from a mass asset account. The Report states that the mortality dispersion tables set forth in the proposed regulations to facilitate the application of recapture rules without requiring the identification of individual assets cannot be applied easily to diverse assets. The Report concludes by stating that, in view of the repeal of the investment credit, the primary reason for restricting a taxpayer's ability to establish mass asset vintage accounts is removed.[157]

F. Alternative Depreciation System

1. General

Revised §168(g)(1) requires the use of the "alternative depreciation system" to compute the depreciation deduction for the following categories of property:

(i) Any tangible property which during the taxable year is used predominantly outside the U.S.;

(ii) Any tax-exempt use property;

(iii) Any tax-exempt bond financed property;

(iv) Any imported property covered by an Executive Order.

The alternative depreciation system must also be used for any property subject to the revised ACRS in determining corporate earnings and profits.[158] The alternative depreciation system, with modifications for §1245 property, is also used for purposes of the revised alternative minimum tax that applies to corporate and non-corporate taxpayers for taxable years beginning after 1986.[159]

Finally, taxpayers may elect the application of the alternative depreciation system with respect to property that otherwise would be depreciated in accordance with the general rules of the revised ACRS.[160]

Under the alternative depreciation system, the depreciation deduction must be computed by using (i) the straight-line method (disregarding salvage value), (ii) the applicable convention as determined under revised §168(d) for the particular type of property involved, and (iii) a recovery period that is generally based upon ADR class life. *See* revised §168(g)(2).

2. Categories of Property Included

a. Foreign Property

Property used predominantly outside the U.S. must be depreciated using the alternative depreciation system.[161] In determining whether property is used predominantly outside the U.S., rules similar to those contained in §48(a)(2), including the exceptions set forth in §48(a)(2) (B),[162] apply. The pre-1986 TRA ACRS [163] incorporates the same §48(a)(2) rules for determining whether property constitutes foreign-use property. In addition, the revised ACRS [164] adds an exception for any satellite or other spacecraft (or interest therein) held by a U.S. person if the satellite or spacecraft was launched from within the U.S.

Under the proposed regulations [165] for the pre-1986

[155] *See* former §168(d)(2)(C).
[156] *See* former §168(d)(2)(A).
[157] Senate Report at 104.
[158] Revised §312(k)(3), as amended by 1986 TRA, §201(b).
[159] Revised §56(a)(1), as added by 1986 TRA, §701(a).
[160] Revised §168(g)(1)(E).
[161] Revised §168(g)(1)(A).
[162] Revised §168(g)(4).
[163] Former §168(f)(2)(D).
[164] Revised §168(g)(4).
[165] Prop. Regs. §1.168-2(g)(5)(i).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

TRA ACRS, the foreign use determination is made by comparing the period in the taxable year during which the property is physically located outside the U.S. with the period during which the property is physically located within the U.S., and if the property is physically located outside the U.S. for more than 50% of the taxable year, the property is considered used predominantly outside the U.S. during that year. These principles apply regardless of whether the property is used outside the U.S. by the owner or by the lessee of the property. For leased property, the taxable year of the lessor is used to determine whether the property for the taxable year is used predominantly outside the U.S.[166]

The §48(a)(2)(B) exceptions to the foreign use rules generally include U.S. registered property used in transportation between the U.S. and foreign countries, equipment used by a U.S. owner in communications, and property used by a U.S. owner in offshore drilling or mineral exploration.

b. Tax-Exempt Use Property

(1) General

Revised §168(h) incorporates rules substantially identical to the rules of the former §168(j) to determine whether property constitutes "tax-exempt use" property. These rules were first enacted by the Tax Reform Act of 1984.[167] In addition to incorporating the prior rules into revised §168(h), the 1986 TRA made various technical corrections to the 1984-enacted provisions, and these technical corrections are also incorporated for purposes of the revised §168(h) rules.[168] Since the tax-exempt use property rules are quite detailed, they will be briefly reviewed below. However, any 1986 TRA technical correction of major importance is discussed.

For nonresidential real property and residential rental property, tax-exempt use property is that portion of the property leased to a tax-exempt entity in a "disqualified lease." *See* revised §168(h)(1)(B) and (E). A "disqualified lease" is defined in revised §168(h)(1)(B)(ii) as any lease of such real property to a tax-exempt entity if one of the four following criteria are met:

(i) Tax-exempt financing was used to finance all or part of the property and the tax-exempt entity (or related entity) participated in the financing;

(ii) There is a fixed or determinable purchase price or sale option, or equivalent of such option, involving the entity (or related entity);

(iii) The lease term exceeds twenty years;

(iv) The property was the subject of a sale and leaseback, or a lease and leaseback, more than three months after the property was first used by the tax-exempt entity (or a related entity).

Non-residential real property or residential rental property is not treated, however, as tax-exempt use property unless the portion leased to tax-exempt entities in disqualified leases is more than 35% of the property. Moreover leases of less than three years are disregarded.[169]

For property other than residential rental or non-residential real property, tax-exempt use property is that portion of any tangible property leased to a tax-exempt entity.[170] However, property subject to a short-term lease, the term of which is (i) less than three years, and (ii) less than the greater of one year or 30% of the property's ADR class life, is not treated as tax-exempt use property.[171]

If property leased to a tax-exempt entity is predominantly used by the tax-exempt entity (either directly or through a partnership of which the entity is a partner) in an unrelated trade or business subject to tax under §511, the property is not treated as tax-exempt use property to the extent of the portion so predominately used.[172]

Note: A technical correction[173] incorporated into the revised ACRS clarifies that any portion predominantly used in an unrelated trade or business will also not be counted in determining if the 35% threshold test for real property has been exceeded.

With certain exceptions, qualified technological equipment, such as computers or high technology telephone equipment,[174] are not treated as tax-exempt use property if the lease with tax-exempt entity has a term of five years or less. *See* revised §168(h)(3)(A).

In determining the lease term for purposes of the foregoing rules, options to renew are generally taken into account, except that options to renew at fair market value (determined at the time of renewal) on nonresidential real property or residential rental property are disregarded. Moreover, two or more successive leases that are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property are treated as one lease.[175]

(2) Definition of Tax-Exempt Entity

The term "tax-exempt entity" is defined in revised §168(h)(2) and generally includes:

(i) the U.S., any U.S. possession, any state or local government, or any agency or instrumentality of any of the foregoing;

(ii) any organization exempt from income tax (other than a §521 agricultural cooperative); and

(iii) any foreign person or entity (excluding any foreign partnership or other foreign pass-through entity — *see* revised §168(h)(2)(C), last sentence).

Certain previously tax-exempt organizations may also be treated as tax-exempt entities under revised §168(h)(2)(E). However, property used by a foreign person or entity is not treated as tax-exempt use property if more than 50% of the gross income for the taxable year derived

[166] Prop. Regs. §1.168-2(g)(5)(ii).
[167] P.L. 98-369, §31.
[168] 1986 TRA, §1802, sets forth the tax-exempt entity technical corrections.
[169] *See* revised §168(h)(1)(B) and (C).
[170] Revised §168(h)(1)(A).
[171] Revised §168(h)(1)(C).
[172] Revised §168(h)(1)(D).
[173] 1986 TRA, §1802(a)(1).
[174] *See* the analysis of the definition of qualified technological equipment II, C, 3, c, *supra*.
[175] Revised §168(i)(3).

by the foreign person or entity from the property's use is subject to U.S. income tax or included in the income of a U.S. shareholder for the taxable year under §951.[176]

(3) Partnership Special Rules for Partnerships and Other Pass-through Entities

Special rules apply to partnerships and other pass-through entities. If property is leased to a partnership or other pass-through entity having a tax-exempt entity as a member, the tax-exempt entity lease rules are applied by treating each tax-exempt entity partner's proportionate share of the leased property as being leased to such partner.[177]

An additional special rule may apply to convert partnership property that is not otherwise tax-exempt use property into tax-exempt use property to the extent that the partnership disproportionately allocates losses and credits away from the tax-exempt entity partners to taxable partners.[178]

For purposes of the foregoing two special partnership rules, the technical correction provisions of the 1986 TRA [179] institute a new rule that will treat any "tax-exempt controlled entity" as a tax-exempt entity. A "tax-exempt controlled entity" is any corporation that is not otherwise a tax-exempt entity if 50% or more (by value) of the corporation's stock is held by one or more tax-exempt entities, applying the constructive ownership rules of §318 (but without regard to the the 50% limitation in §318(a)(2)(C)). For purposes of the pre-1986 TRA ACRS, this rule applies generally to property placed in service after September 27, 1985.[180]

Perhaps in recognition of the potential sweeping application of this definition—many public corporations could conceivably be treated as tax-exempt controlled entities because of the widespread ownership of their stock by tax-exempt organizations such as pension trusts — the revised ACRS [181] modifies the 50% test to exclude stock that is publicly traded on an established securities market unless the tax-exempt entity (combined with related entities) holds at least 5% (in value) of the stock of the corporation.

An election is provided under which a tax-exempt controlled entity can elect not to be treated as a tax-exempt entity for purposes of the partnership rules. The election, which is irrevocable and is binding on all tax-exempt entities holding interests in the tax-exempt controlled entity, requires that any gain recognized by the tax-exempt owner on any disposition of an interest in the entity, and any dividends or interest received or accrued by a tax-exempt entity from the controlled entity, be treated as unrelated business taxable income for purposes of the §511 tax.[182]

c. Tax-Exempt Bond Financed Property

The term "tax-exempt bond financed property" is defined as any property to the extent the property is financed directly or indirectly by an obligation the interest on which is exempt under §103(a).[183]

This definition is broader than definition used for purposes of the pre-1986 TRA ACRS.[184] Under the pre-1986 TRA ACRS, only property financed with the proceeds of an industrial development bond that carries tax-exempt interest is subject to a cost recovery limitation — namely the use of the straight-line method.[185]

Excluded from "tax-exempt bond financed property" is a qualified residential rental project as defined in §142(a)(7) (generally, low-income housing financed by a tax-exempt bond).[186] If only a portion of a facility is financed with a tax-exempt bond, revised §168(g)(5)(B) allocates the bond proceeds to the property first placed in service.

Because the 1986 TRA expands the definition of tax-exempt bond financed property to encompass all tax-exempt financing, special effective dates apply.[187] In general, the expanded definition applies only to the extent property placed in service after December 31, 1986, is financed by the proceeds of an obligation (including a refunding obligation) issued after March 1, 1986. Moreover, the expanded definition does not apply to a facility described in an inducement resolution or other comparable preliminary approval adopted by the issuing authority (or by vote or referendum) before March 2, 1986, if one of the following conditions is met:

(i) The original use of the facility commences with the taxpayer, and the construction, reconstruction, or rehabilitation of the facility began before March 2, 1986, and was completed on or after the March 2nd date;

(ii) With respect to the facility a binding contract to incur "significant expenditures" (more than 10% of the reasonably anticipated costs) for construction, reconstruction, or rehabilitation was entered into before March 2, 1986, and some of the expenditures are incurred on or after that date, or

(iii) The facility is acquired on or after March 2, 1986, pursuant to a binding contract entered into before that date.

Refunding obligations are subject to special transition rules that may further diminish the application of the expanded definition.[188]

d. Executive Order Imported Property

Revised §168(g)(6) authorizes the President to issue an Executive Order to require the application of the alternative depreciation system to certain property imported from a foreign country that maintains nontariff trade restrictions substantially affecting U.S. commerce or that engages in

[176] Revised §168(h)(2)(B).
[177] Revised §168(h)(5). It is presumed that the members of a foreign partnership or other foreign pass-through entity are tax-exempt entities for purposes of the tax-exempt use property rules unless otherwise established to the Service's satisfaction. Revised §168(h)(5)(C).
[178] *See* revised §168(i)(6).
[179] 1986 TRA, §1802(a)(2)(E).
[180] 1986 TRA, §1802(a)(2)(E)(ii).
[181] Revised §168(h)(6)(F)(iii)(II).
[182] Revised §168(h)(6)(F)(ii).
[183] Revised §168(g)(5)(A).
[184] *See* former §168(f)(12)(A).
[185] Former §168(f)(12)(A) and (B).
[186] Revised §168(g)(5)(C).
[187] 1986 TRA, §203(c).
[188] *See* 1986 TRA, §203(c)(2)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

discriminatory actions or policies restricting U.S. commerce.

3. Computation of Alternative Depreciation Deduction

Revised §168(g)(2) provides that the depreciation deduction under the alternative depreciation system is determined by using (i) the straight-line method, without regard to salvage value, (ii) the applicable convention determined under revised §168(d), and (iii) a recovery period that is generally based upon the ADR class life.

The rules for determining the ADR class life are analyzed in II, C, 2, *supra*. However, for purposes of the alternative depreciation system,[189] a new class life is assigned to certain property, as follows:

Property	*Class Life*
Semi-Conductor Manufacturing Equipment	5
Computer-based Telephone Central Office Switching Equipment	9.5
Railroad Track	10
Single-Purpose Agricultural or Horticultural Structure	15
Municipal Waste Water Treatment Plant	24
Telephone Distribution Plant and Comparable Equipment Used for Two-Way Exchange of Voice and Data Communication	24
Municipal Sewers	50

In addition, the statute [190] provides that the recovery period for qualified technological equipment, such as computers, and for automobiles and light general purpose trucks is five years. Moreover, for any §1245 property which is real property with no class life, the recovery period is forty years, [191] and for personal property with no class life the recovery period is twelve years.[192]

The recovery period under the alternative depreciation system for nonresidential real and residential rental property is 40 years.[193] Moreover, for any tax-exempt use property subject to a lease, the recovery period may in no event be less than 125% of the lease term.[194]

As previously mentioned, the straight-line method is used under the alternative depreciation system. However, for purposes of the revised alternative minimum tax,[195] which applies the alternative depreciation system to determine the minimum tax depreciation adjustment, the 150% declining balance method with a switch to the straight-line method is used for all property subject to the revised ACRS except §1250 property and any other property for which straight-line is required or elected for revised ACRS purposes.

4. Election of Alternative Depreciation System

Revised §168(g)(7) provides a taxpayer with an irrevocable election to use the alternative depreciation system as to all property in a particular revised ACRS category placed in service during a taxable year. For example, if a taxpayer places in service during 1987 an automobile, a computer, and a copying machine, all of which are in the 5-year class, and a race horse, which is in the 3-year class, and the taxpayer makes the election with respect to 5-year property, the auto, computer, and copying machine will be subject to the straight-line deduction computed under the alternative depreciation. The race horse, however, will not.

As to residential rental property and nonresidential real property, the election of the alternative depreciation system may be made separately with respect to each property.[196]

G. *Miscellaneous Rules*

1. Improvements and Additions

The revised ACRS [197] prohibits component depreciation for all property subject to the revised ACRS in much the same manner as component depreciation of real property is prohibited under the pre-1986 TRA ACRS.[198] Under the revised ACRS, the depreciation deduction for an addition or an improvement must be computed in the same manner as the deduction would be computed if the property to which the addition or improvement is made was placed in service at the same time as the addition or improvement. Moreover, the applicable recovery period for the addition or improvement must begin on the later of (i) the date when the addition or improvement is placed in service, or (ii) the date on which the property to which the addition or improvement is made is placed in service.

Note: In contrast to the pre-1986 TRA ACRS, there is no exception to this rule if a "substantial improvement" is made at least three years after the property to which the addition or improvement relates is placed in service.

2. Nontaxable Transfers

Revised §168(i)(7) provides that if property is transferred under §332 (subsidiary liquidations), §351 (transfers to controlled corporations), §361 (corporate reorganizations), §371(a) or §374(a) (certain bankruptcy reorganizations), §721 (transfers to partnerships), or §731 (partnership distributions), then the transferee's depreciation deduction is determined in the same manner as the transferor's deduction would be determined with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. This rule does not apply, however, if a partnership is terminated under §708(b)(1)(B) by reason of the sale or exchange of at least 50% of the capital or profits interest in the partnership within a 12-month period. Moreover, the foregoing rule does not apply to any transaction to which the anti-churning rules of revised §168(f)(5) apply.

Note: In contrast to the pre-1986 TRA ACRS,[199] no special rule is provided for transfers in which gain is not

[189] Revised §168(g)(3).
[190] Revised §168(g)(3)(C) and (D).
[191] Revised §168(g)(3)(E).
[192] Revised §168(g)(2)(C)(ii).
[193] Revised §168(g)(2)(C)(iii).
[194] Revised §168(g)(3)(A).
[195] Revised §56(a)(1)(A).
[196] Revised §168(g)(7)(A).
[197] Revised §168(i)(6).
[198] *See* former §168(f)(1).
[199] *See* former §168(f)(7).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

recognized in whole or in part, such as on a like-kind exchange under §1031 or on a gift. Presumably, since the revised ACRS allows a depreciation deduction using the applicable convention with respect to any property in the year of disposition, special rules were not believed to be necessary. Under the pre-1986 TRA ACRS, in contrast, a deduction would not be allowed upon the nontaxable disposition of personal property but for the existence of the special rules. *See* former §168(d)(2)(B).

3. Reacquisitions

The revised ACRS [200] provides that if property is disposed of and then reacquired by the taxpayer, the taxpayer will be required under regulations to compute the depreciation deduction as if the property had not been disposed of. This rule does not apply, however, if the anti-churning rules apply to the reacquisition. Revised §168(i)(7)(D).

4. Leasehold Improvements

Revised §168(i)(8) provides that if a building is erected, or an improvement made, on leased property, and if the building or improvement is property to which the revised ACRS applies, the depreciation deduction must be determined under the revised ACRS. This rule is designed to foreclose the option provided under the pre-1986 TRA ACRS rules [201] that allows lessees to amortize leasehold improvements over the term of the lease if the remaining lease term is shorter than the recovery period for the leasehold improvement.

In a conforming change, §178 is amended to narrow its application. As amended, §178 applies only in determining the length of a lease term for purposes of amortizing lease acquisition costs.[202] However, in a change from pre-1986 TRA law, §178 is applied for purposes of lease acquisition costs by treating the term of the lease as including all renewal options as well as any period for which the parties reasonably expect the lease to renewed.

H. Changes in Expensing Provisions

Under pre-1986 TRA law, §179 permitted a taxpayer to expense up to $5,000 of property that would otherwise qualify for the investment credit if acquired by purchase for use in a trade or business. If the expensed property ceased to be used predominantly for business within two taxable years after the taxable year in which the property was placed in service, the difference between the amount expensed and the ACRS deductions that would have been allowed for the period of business use was recaptured as ordinary income. *See* Prop. Regs. §1.179-1(e)(1). If a husband and wife filed separate returns, the $5,000 expensing limit was reduced to $2,500 apiece. *See* former §179(b)(2).

The 1986 TRA makes the following changes to §179.[203] The 1986 TRA raises the dollar ceiling on the amount that may be expensed to $10,000 if the taxpayer's total investment in qualifying property for the year is $200,000 or less. If the qualifying property placed in service during the year exceeds $200,000, the $10,000 ceiling is reduced by one dollar for every dollar of investment exceeding $200,000. Moreover, the aggregate amount expensed under §179 for any taxable year may not exceed the taxpayer's taxable income for that year derived from the active conduct by the taxpayer of any trade or business during such year. Taxable income is determined without regard to the amount to be expensed under §179. To the extent a deduction is not allowed because of the lack of taxable income, the unused cost is carried to the succeeding taxable year and added to the amount allowable as a deduction for such succeeding taxable year. *See* §179(b).

Married individuals filing separate returns are treated as one taxpayer for purposes of determining the amount that may be expensed and the total amount of investment in qualifying property.[204]

Finally, the expensing recapture rule is modified. Instead of limiting recapture to cases in which the business use percentage drops to 50% or less within two taxable years after the year the property is placed in service, the revised rule, contained in §179(d)(10), states that regulations are to provide for recapture when expensed property is not used predominatly in a trade or business "at any time." Thus, regulations may require the recapture of the difference between the expensed amount and ACRS deductions if the property is converted for nonbusiness use at any time before the end of the property's recovery period.[205]

I. Technical Corrections to pre-1986 TRA ACRS

The 1986 TRA [206] makes the following changes to the pre-1986 TRA ACRS in the technical corrections provisions:

1. Section 168(b) is clarified to provide the taxpayers may elect to recover the cost of low-income housing using the straight-line method over 15 years. 1986 TRA, §1809(a)(1).

2. The minimum tax preference rule of pre-1986 TRA §57(a)(12), the corporate earnings and profits depreciation computation rule of pre-1986 TRA §312(k), and various other provisions dealing with the computation of cost recovery with respect to 18 or 19-year real property are clarified to provide that the mid-month convention is to be employed. 1986 TRA, §1809(a)(2) and (5).

3. Section 168(f)(12) is amended to clarify that the cost of 18-year or 19-year real property financed by the proceeds of an industrial development bond, except for low-income housing, cannot be recovered more rapidly than on a straight-line basis over 18 or 19 years, using the mid-month convention. This rule does not apply if the property is either (i) low-income housing, or (ii) property that is placed in service in connection with a project for tax-exempt bond financed residential rental property but does not fit the definition of low-income housing for ACRS purposes. 1986 TRA, §1809(a)(4) and (5).

4. In a change having substantive impact, §168(f)(10) is amended by 1986 TRA, §1809(b), to eliminate the "step

[200] Revised §168(i)(7)(C).
[201] *See* former §168(f)(6) and former §178.
[202] 1986 TRA, §201(d)(2)(A).
[203] 1986 TRA, §202, effective, pursuant to 1986 TRA, §203(a)(2), for property placed in service after 1986.
[204] §179(b)(4).
[205] *See* revised §179(d)(10). *Cf.* Prop. Regs. §1.179-1(e)(1).
[206] 1986 TRA, §1809.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

into the shoes" rule for sale and leaseback transactions and for acquisitions from a related person. Under the "step into the shoes" rule, the transferee's cost recovery deduction with respect to so much of the transferee's basis as is not in excess of the transferor's adjusted basis in the property is the same amount as would have been allowed the transferor if no transfer had occurred. As amended, the transferee will start depreciating the property as would any other new owner of the property. However, to the extent of the adjusted basis of the property in the transferor's hands, the transferee is treated as having made any election, such as the straight-line election, made by the transferor with respect to the property. For example, if the transferor had elected the straight-line rates for 5-year property, the transferee in a sale and leaseback or related party transfer would be treated as having made the same straight-line election to the extent that the transferee's basis was the same as the transferor's. The Senate Report [207] notes that the foregoing amendment is not intended to affect the treatment of transfers between members of an affiliated group filing a consolidated return.

The "step into the shoes" rule is not changed for tax-free asset transfers described in §§332, 351, 361, 371(a), 374(a), 721, or 731, with one exception. In the case of a partnership termination under §708(b)(1)(B), the "step into the shoes" rule is eliminated.

The foregoing amendment generally applies to property placed in service by the transferee after December 31, 1985, in taxable years ending after that date. 1986 TRA, §1809(b)(3). The first three amendments discussed above generally apply with respect to property placed in service by the taxpayer after March 15, 1984. *See* 1986 TRA, §1881, and 1984 TRA, §111(g)(1).

[207] Senate Report at 932.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 5

NEW RESTRICTIONS ON INTEREST DEDUCTION [ACT §511]

Deborah M. Beers, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. General Rule

The limitation on deductibility of investment interest was enacted as part of the Tax Reform Act of 1969.[1] For investment interest incurred before 1972, so-called "excess investment interest" was treated as a tax preference item subject to a minimum tax under §56.[2] For taxable years beginning after 1971, excess investment interest ceased to be an item of tax preference and became an item subject to limited deductibility.[3]

The Tax Reform Act of 1976[4] made significant changes to the statutory limitations on deductibility of investment interest. These changes, with minor modifications, governed the tax treatment of investment interest until the passage of the Tax Reform Act of 1986. Under the 1976 Act, interest on investment indebtedness incurred by noncorporate taxpayers generally was limited to $10,000, plus the taxpayer's net investment income. No offset of investment interest was permitted against capital gain income. A taxpayer could also deduct an additional $15,000 per year for interest paid or accrued in connection with investment indebtedness incurred by the taxpayer to acquire stock in the corporation, or a partnership interest, where the taxpayer, spouse and children owned, at least 50% of the stock or capital interest in the enterprise. Any interest which was disallowed under these rules was subject to an unlimited carryover and could be deducted in future years (subject to the applicable limitation).

Under the 1976 Act, no limitation was imposed on the deductibility of personal interest.[5]

The Act also included requirements for the capitalization and amortization of real property construction period interest and taxes. §189.

B. Definition of "Investment Interest"

"Investment interest" is defined by pre-1986 TRA §163(d)(3)(D)(i) as interest "paid or accrued" on indebtedness "incurred or continued" to "purchase or carry" property held for investment. This definition alone was provided by §163(d)(3)(D) prior to its amendment by the Tax Reform Act of 1984 (P.L. 98-369). Section 56(b) of P.L. 98-369 added §163(d)(3)(D) (ii) which provides that, for purposes of the above definition, "interest" includes any amount allowable as a deduction in connection with personal property used in a short sale.

C. The Tracing Problem

The general definition of "investment interest" in §163(d)(3)(D)(i) involves language similar to that of §265(2) (relating to the disallowance of interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations) §264(a) (concerning indebtedness incurred or continued to purchase or carry certain life insurance, endowment and annuity contracts), and §1277(c) (relating to the disallowance of certain interest paid or accrued on indebtedness incurred or continued to purchase or carry certain types of bonds). All involve problems of tracing.

1. Prop. Regs. §1.57-2(b)(1)(iii)

While there have been no regulations issued under §163(d), proposed regulations under §57 (minimum tax) indicate the probable IRS interpretation of words and phrases contained in §163(d).[6] The proposed regulations adopt a facts and circumstances approach. Under Prop. Regs. §1.57-2(b)(iii), where indebtedness is incurred or paid solely for the purpose of purchasing or carrying property which is used in a trade or business or which is clearly property for personal use (home, automobile, boat, etc.), the interest on the indebtedness will not be treated as investment interest. Similarly, where indebtedness can be traced to a particular activity or property, the character of the interest expense will be determined by the nature of the activity or property. The following excerpt from Prop. Regs. §1.57-2(b)(1)(iii) indicates the probable IRS approach to situations in which tracing becomes more complex:

---

[1] P.L. 91-172, 91st Cong. 1st Sess., §221 (1969). For a general discussion of the rules applicable to the deductibility of investment interest, *see* 279 T.M., *Interest Expense Deductions.*

[2] *See* Code §57(a)(1), (b).

[3] *See* H.R. Rep. No. 782 (Conf.), 91st Cong., 1st Sess. 302 (1969).

[4] P.L. 94-455, 94th Cong. 2d Sess., §§201 and 209 (1976).

[5] *See* Code §163(a), (d).

[6] Note that these particular regulations were not adopted when other final minimum tax regulations were adopted on Sept. 12, 1978. *See* T.D. 7564, 43 Fed. Reg. 40459 *et seq.* (Sept. 12, 1978). Retroactive changes made to the minimum tax provisions by the Revenue Act of 1971 (P.L. 92-178) were cited as the reason for the failure to adopt these sections of the proposed regulations.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

"In addition, if substantially identical amounts are borrowed and expended simultaneously it will be inferred that the resulting indebtedness was incurred for the purpose of such expenditure. Indebtedness which was originally incurred for one purpose may be continued for another purpose. Thus, if the taxpayer incurred an indebtedness to purchase business property but continued the indebtedness in order to avoid liquidation of property held for investment, the indebtedness is continued in order to carry the property held for investment. An indebtedness may be incurred or continued for multiple purposes. Where such a multiple purpose is established, including an investment purpose, a portion of the loan will be treated as incurred or continued in order to purchase or carry property held for investment. In cases where the proceeds of an indebtedness cannot be traced by application of the principles of this subdivision to a particular activity or property, it will be inferred that the indebtedness was incurred or continued in order to carry property held for investment. In some cases, however, it may be established that all or part of such indebtedness was not incurred or continued in order to carry property held for investment. Thus, where a taxpayer owns $100,000 in value of appreciated investment property, indebtedness in excess of that amount will ordinarily not be considered to be incurred or continued in order to carry investment property."

The following examples illustrate the proposed IRS approach to determining whether indebtedness was incurred or continued to purchase or carry property held for investment:

"*Example (1):* A taxpayer obtained an unsecured loan of $100,000 on March 16, 1970. On the same day, he purchased securities of a company in the amount of $120,000. It will be inferred that the $100,000 loan was incurred for the purpose of purchasing such securities.

"*Example (2):* A taxpayer who owns substantial amounts of business property and investment property with a value in excess of $150,000 obtains an unsecured loan of $150,000 on June 5, 1970. The taxpayer is unable to show that the loan was for business or personal, as opposed to investment, use. It will be inferred that the loan was incurred for the purpose of purchasing or carrying investment property.

"*Example (3):* The facts are the same as in example 2, except that the taxpayer is able to establish that he owned no more than $70,000 of investment property during the taxable year, it will be inferred that only seven-fifteenths of the loan was incurred for the purpose of purchasing or carrying investment property.

"*Example (4):* If, under the facts of Example 3, the taxpayer obtained two different loans totaling $150,000 at different interest rates, seven-fifteenths of each loan will be considered indebtedness incurred or continued to purchase or carry property held for investment."

2. Cases under §265

As noted above, §265(2) disallows a deduction for interest on indebtedness "incurred or continued" to "purchase or carry" tax-exempt obligations. Under §265, where there is no demonstrably direct link between the borrowing and the tax-exempt obligations, circumstantial evidence must be used to establish a reasonable inference of a "sufficiently direct relationship" between the borrowing and the investment in tax-exempts.[7]

In Rev. Rul. 82-163,[8] the IRS applied the §265 analysis used by the Tax Court in *Mariorenzi*[9] to analyze the relationship between a loan and other concommitant activities engaged in by the taxpayer. The Service ruled that interest was investment interest subject to §163(d) in the following situation:

B, a customer of X, qualified for and obtained a second mortgage loan from Y of $100x. B deposited the proceeds in B's account in a savings and loan association. One month later, B withdrew $100x from the saving account to purchase an interest in a managed commodity fund. B's investment in this fund was arranged by X, but this investment was not part of B's securities account.

In the same ruling, the Service concluded that interest was not subject to the §163(d) limitations in the following situation:

The taxpayer, A, is a customer of X, a brokerage firm that is a member of a national securities exchange. Y, an affiliate of X and engaged in the mortgage lending business, offered A a loan secured by a second mortgage on A's personal residence. This loan was available only to customers of X who had a securities account with the net value of at least 50% of the amount of the loan. A qualified for a loan of $50x and used the entire proceeds to construct an addition to A's personal residence. The loan agreement provided that interest on the loan will be paid from A's securities account.

D. Persons Subject to §163(d)

The investment interest limitation applies to any "taxpayer other than a corporation."[10] Thus, the provision applies to individuals, trusts and estates. However, the provision does not apply to partnerships or to S corporations as such. Instead, investment income and expenses are treated as flowing through to the partners and S corporation shareholders with any applicable limitation being imposed at the partner or shareholder level, as the case may be.[11] Pre-1986 TRA treatment of interest incurred to purchase or carry an interest in an S corporation or partnership, however, is not entirely clear.[12] Prop. Regs. §1.57-2(b)(2)(i) implies that the interest would not be

---

[7] *See* Rev. Proc. 72-18, 1972-1 C.B. 740. *See also Mariorenzi v. Comr.*, 32 T.C.M. 681 (1973), *aff'd per curiam*, 490 F.2d 92 (1st Cir. 1974); *Wisconsin Cheeseman v. U.S.*, 338 F.2d 420 (7th Cir. 1986); *Norfolk Shipbuilding and Drydock Corp.*, 321 F.Supp. 222 (E.D.Va. 1971); *Bishop v. Comr.*, 342 F.2d 757 (6th Cir. 1965); *Illinois Terminal Railway Co. v. U.S.*, 375 F.2d 1016 (Ct.Cl. 1967); *Ball v. Comr.*, 54 T.C. 1200 (1970); and *Bradford v. Comr.*, 60 T.C. 253 (1973).

[8] 1982-2 C.B. 57.

[9] 32 T.C.M. 681 (1973), aff'd *per curiam*, 490 F.2d 92 (1st Cir. 1974).

[10] Section 163(d)(1).

[11] Pre-1986 TRA §§703(b)(3) and 1363(c)(2)(A).

[12] *See* H.R. Rep. No. 426, 99th Cong., 2d Sess. 296 (1985).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

investment interest where the underlying assets are not investment assets.[13]

In the case of trusts and estates, a modified flow-through principle appears to apply.[14] It would seem that the flow-through principle will apply to the extent that trust and estate income is actually distributed to the beneficiaries.[15] Thus, the trust or estate apparently would be subject to the limitation formula to the extent that it did not distribute its income. Finally, note that, in the case of a trust, the amount of the deductible investment interest is limited to the net investment income (*i.e.*, the $10,000 base found in §163(d)(1)(A) does not apply).[16]

E. Net Investment Income Factor

Under pre-1986 TRA §163(d)(1)(B), the term "net investment income" means the excess of investment income over investment expenses.[17] Investment income is defined more specifically as:

> (i) Gross income from interest, dividends,[18] rents and royalties,
>
> (ii) The net short-term capital gain attributable to the disposition of property held for investment, and
>
> (iii) Any amount treated under §§1245, 1250 and 1254 as ordinary income,

but only to the extent such income, gains and amounts are not derived from the active conduct of a trade or business.[19]

The term "investment expenses" means ordinary and necessary business expenses, real property taxes, bad debts, depreciation (determined under the straight-line method),[20] amortization, non-business expenses attributable to production of income or maintenance of property, and depletion (cost rather than percentage).[21]

F. Special Rules

Under a special rule, property subject to a net lease is treated as property held for investment, and not property used in a trade or business if, for a taxable year, (i) the sum of the deductions of the lessor with respect to the property which are allowable solely by reason of §162 (other than rents and reimbursed amounts with respect to such property) is less than 15% of the rental income produced by the property, or (ii) the lessor is either guaranteed a specific return or is guaranteed in whole or in part against loss of income.[22] In addition, interest paid or accrued on indebtedness incurred or continued in the construction of property to be used in a trade or business shall not be treated as investment interest.[23]

II. Overview

A. Investment Interest

1. Elimination of $10,000 Deductible Amount

The Tax Reform Act of 1986 (P.L. 99-514), §511(a), revises the §163(d) investment interest limitation for noncorporate taxpayers to make it more restrictive. As revised, the $10,000 deductible amount (increased, under pre-1986 TRA law, by $15,000 to $25,000 for debt incurred for certain closely-held business interests as explained above) is completely eliminated. Investment interest may only offset net investment income.

2. Passive Loss Coordination

To coordinate the revised §163(d) investment interest limit with the passive loss rules of §469, revised §163(d)(3)(B) excludes as investment interest any interest taken into account in determining passive activity income or loss under §469. Since the passive loss limits encompass all rental property, including net lease property that was formerly covered by §163(d) (*see* Conference Report at II-138), revised §163(d) completely eliminates the special rules for net lease property. However, revised §163(d)(5)(A) provides that "property held for investment" includes (i) property which produces "portfolio income" (which is excluded from passive loss computations) and (ii) any ownership interest held by a taxpayer in an activity involving the conduct of a trade or business which is not a passive activity and with respect to which the taxpayer does not materially participate. An example of this type of activity would be any working interest in any oil or gas property which the taxpayer holds directly or through a general partnership interest.[24]

B. Personal Interest

The 1986 TRA, Act §511(b), adds new §163(h) to the Code, disallowing deductions for "personal interest" paid or accrued during the taxable year by a noncorporate taxpayer. Section 163(h)(2) defines the term "personal interest" as any interest allowable as a deduction for income tax purposes other than:

> (i) Interest paid or accrued on debt incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee);
>
> (ii) Any §163(d) investment interest;
>
> (iii) Any interest taken into account under new §469 in computing passive activity income or loss;
>
> (iv) Any "qualified residence interest"; and
>
> (v) Any interest payable on estate tax deferred under §§6163 or 6166.

---

[13] *Compare* Rev. Proc. 72-18, *supra* §4.05 (relating to §265) and §163(d)(7).

[14] *See* Form 4952, "Investment Interest Expense Deduction."

[15] *See* Instructions, Form 4952.

[16] Pre-1986 TRA §163(d)(1) (last sentence).

[17] §163(d)(3)(A).

[18] In a case invovling pre-1983 law, the Tax Court decided that the income of a subchapter S corporation did not retain its character when passed to the individual stockholders and sub S "dividends" were dividends for purposes of §163(d). Under the subchapter S Revision Act of 1982, P.L. 97-354, subchapter S was substantially rewritten to treat S corporations more or less as conduits so that income character is passed through. The Tax Court noted that, under the 1982 Act, operating income of a S corporation would presumably no longer qualify as investment income for purposes of §163(d). *Crook v. Comr.*, 80 T.C. 27 (1983).

[19] Pre-1986 TRA §163(d)(3)(B).

[20] *See* PLR 8340024.

[21] Pre-1986 TRA §163(d)(3)(C).

[22] Pre-1986 TRA§163(d)(4)(A).

[23] Pre-1986 TRA §163(d)(4)(B).

[24] *See* Code §469(c)(3).

The foregoing definition thus treats as "personal interest" interest on debt incurred by an employee to purchase an item such as a car or computer used by the employee in the course of his employment. Personal interest will also include any interest that accrues on a tax deficiency. *See* Conference Report at II-154.

C. Related Provisions

The 1986 TRA also makes change to other provisions relating to the tax treatment of interest including: amortizable bond premium (§171); capitalization of interest (§263A); loans from certain life insurance contracts (§264(a)); and alternative minimum tax itemized deductions (§56).

III. Detailed Analysis

A. Investment Interest Limitations

1. General Rule

As noted above, a noncorporate taxpayer's investment interest may not exceed the net investment income of the taxpayer for the taxable year.[25] Any amounts not allowed as a deduction by reason of the general limitation may be carried over and deducted as investment interest paid or accrued in the succeeding taxable year to the extent that the taxpayer has investment income in that year. §163(d)(2).

2. "Investment Interest" Defined

The term "investment interest" as it appears in new §163(d)(3) is generally the same as that under the old law, *i.e.*, it includes interest "which is paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." The term "investment interest" does not, however, include:

(i) Any qualified residence interest (discussed below); or

(ii) Any interest which is taken into account under §469 in computing income or loss from a passive activity of the taxpayer.[26]

3. "Property Held for Investment" Defined

The term "property held for investment" generally includes (i) any property which produces income of a type described in §469(e)(1) (*i.e.*, portfolio income), and (ii) any interest held by a taxpayer in an activity involving the conduct of a trade or business which is not a passive activity and with respect to which the taxpayer does not materially participate. §163(d)(5). Under §163(d)(5)(C), the terms "activity", "passive activity" and "materially participate" taxpayers have the meanings given such terms by §469.

Section 469(e)(1) portfolio income includes gross income from interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business (*i.e.*, most types of passive income other than rental income), as well as gain or loss attributable to the disposition of such property.

The term "material participation" as defined in §469(h) requires taxpayer involvement in the operation of an activity on a basis which is regular, continuous *and* substantial. However, any rental activity (other than with respect to working interests in oil and gas property and certain rental real estate activities undertaken by natural persons who "actively participate" within the meaning of §469(i)(6) in such activity) is included in the term "passive activity" without regard to whether the taxpayer materially participates in the activity.[27]

Note: While the material participation standard of §469 is based on §1402(a) (relating to the self-employment tax) and Code §2032A (relating to estate tax valuation of farm property), existing authorities interpreting §§1402(a) and 2032A are not expected to be controlling for purposes of the passive loss (and thus the investment interest) rules.[28]

Note: The active participation requirement is waived with respect to credits under §42 (low income housing) and §48(o) (rehabilitation).[29]

Conversely, the term "passive activity" does not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest, regardless of whether the taxpayer materially participates in the activity.[30] Therefore, a working interest in oil or gas property held by the taxpayer through a general partnership interest would be subject to the investment interest limitations (assuming that the taxpayer does not materially participate in such activity) because it is not covered by the passive loss rules.

In a change from pre-1986 TRA law, property subject to a net lease is not treated as investment property, since it is treated as a passive activity under the passive loss rule.[31] Other exclusions from the investment interest limitations are (a) interest expense which in the same year is required to be capitalized (*e.g.*, construction interest subject to new Code §263A) and (b) interest disallowed under §265 (relating to tax-exempt interest).[32]

4. "Net Investment Income" Defined

As under pre-1986 TRA law, the term "net investment income" means the excess of investment income over investment expenses.[33] The term "investment income" in turn means the sum of the gross income from property held for investment and any net gain attributable to the disposition of such property, but only to the extent that such amounts are not derived from the conduct of a trade or business. §163(d)(4)(B).

In netting investment expenses against investment income, only those investment expenses that are allowed after

[25] §163(d)(1).
[26] §163(d)(3)(B).
[27] §469(c)(4).
[28] *See* S. Rep. No. 313, 99th Cong. 2d Sess., 732 (1986) (hereafter "Senate Report").
[29] §496(i)(6)(B).
[30] Code §469(c)(3) and (4).
[31] *See* H.R. Rep. No. 514, 99th Cong., 2d Sess. II-154 (1986) (hereafter "Conference Report").
[32] *Id.*
[33] §163(d)(4)(A).

application of the 2% adjusted gross income floor for miscellaneous expenses are to be taken into account.[34] Moreover, in computing the amount of expenses that exceed the 2% floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.

5. Persons To Whom Limitations Apply

As under pre-1986 TRA law, the investment interest limitation applies to any "taxpayer other than a corporation." [35] Therefore, as under prior law, individuals holding an interest in pass-through entities such as partnerships and S corporations should treat investment income and expenses as having flowed through to the partners and S corporation shareholders with any applicable limitation being imposed at the partner or shareholder level, as the case may be.[36] However, under the 1986 Act, it appears that characterization of the flow-through items as investment interest or expense may be made at the entity level. In discussing §469, the Senate Report on §469 contains the following example of the determination, at the limited partnership level, of whether certain items of income or loss of the partnership are characterized either as portfolio income and loss (which would be subject to the investment interest limitations) or income and loss from a passive activity (which would not be so subject to the passive loss limitations):

> "[A partnership that is engaged in the publication of a magazine] also holds a portfolio of dividend and interest-bearing securities, but the income from them is more than offset by the tax losses of operating the magazine. Each limited partner must separately account for his share of the portfolio income and the losses from the operations of the magazine, and may not offset them against each other in calculating his tax liability. The portfolio income retains its character as income that is not income from a passive activity, despite the fact that non-portfolio income and loss attributable to a limited partnership interest is treated as income or loss from a passive activity." [37]

As noted above, Prop. Regs. §1.57-2(b)(2)(i) implies that interest incurred to purchase or carry a partnership interest or S corporation stock would not be investment interest where the underlying assets are not investment assets. Under the 1986 Act, however, the treatment of interest incurred to purchase or carry a partnership or S corporation interest would appear to depend on whether or not the taxpayer holding such interest materially participates in the enterprise in which the partnership or S corporation is engaged.[38]

Presumably, the old rules, described above, apply in the case of trusts and estates, to the extent that trust and estate income is actually distributed to the beneficiaries. However, the Senate Report notes that the grantor of a grantor trust, through his material participation or lack of material participation in a business enterprise in which the trust holds an interest, may determine the characterization of the income or loss and the interest derived from that enterprise.[39]

6. The Tracing Problem

As noted above, if there is a connection in time and amount between a borrowing and expenditure, it may, in some cases, be inferred that the resulting indebtedness was incurred for the purpose of such expenditure.[40] However, making the connection between such an expenditure and indebtedness presents difficult problems of tracing not addressed by the 1986 Act. The Conference Report, in discussing standards appropriate for allocation of expenses and interest under the passive loss rule, suggests that regulations providing guidance to taxpayers with respect to interest allocation under that rule should be issued by December 31, 1986.[41] The Report states that

> "These regulations should be consistent with the purpose of the passive loss rules to prevent sheltering of income from personal service and portfolio income with passive losses. Moreover, the regulations should attempt to avoid inconsistent allocation of interest deductions under different Code provisions [such as §§265 or 291]." [42]

The Report suggests that, in the case of entities (but not individuals) a proper method of allocation (for purposes of the passive loss rules) may include allocation of interest to portfolio income on the basis of assets (although there may be situations in which tracing is appropriate because of the integrated nature of the transactions involved).[43] However, because of the difficulties of recordkeeping that would be required where interest expenses of individuals were allocated rather than traced, interest expense in the case of individuals generally will be traced to the asset or activity which is purchased or carried by incurring or continuing the underlying indebtedness.

7. Effective Dates

TRA 1986 provides a phase-in of the disallowance of deductions for investment interest under the new rules for calendar years 1987 through 1990.[44] Thus, the $10,000 investment interest threshold of former §163(d) is effectively phased-out over four years. Under the phase-out, 65% of up to $10,000 (a maximum of $6,500) of investment interest otherwise disallowed by revised §163(d) is allowed for taxable years beginning in 1987. Up to $4,000 (4% of $10,000) is allowed for taxable years beginning in 1988. A maximum of $2,000 (20% of $10,000) is allowed for taxable years beginning in 1989. Finally, for taxable years beginning in 1990, up to 10% of the $10,000 amount ($1,000) is allowed. The phase-out percentage only applies to investment interest expense incurred during the phase-out year in question. Investment interest suspended in a prior taxable year and carried to another year in the

[34] Conference Report II-153-154.
[35] §163(d)(1).
[36] §§703(b)(3) and 1363(c)(2)(A).
[37] Senate Report at 729.
[38] §163(d)(5)(A). *See also supra* at Senate Report 805.
[39] Senate Report at 805, footnote 4.
[40] *See* Prop. Regs. §1.57-2(b)(1)(iii), quoted above.
[41] Conference Report at II-146.
[42] *Id.*
[43] *Id.*
[44] §163(d)(6).

phase-out period may not be taken into account. *See* Conference Report at II-157.

The phase-in rules of the investment interest limitation are coordinated with the new passive loss rules of §469. Section 163(d)(4)(E) effectively provides that, during the four-year phase-in period of the §469 passive loss limits, the amount of any passive loss allowed under the phase-in will reduce investment income for purposes of determining the amount of investment interest that is allowable for the taxable year. However, the reduction of investment income for the phase-in loss will not be required as to any portion of such loss which is attributable to a rental real estate activity with respect to which the taxpayer actively participates during the taxable year.[45]

B. Personal Interest

Section 511(b) of TRA 1986 adds a new §163(h) which disallows a deduction for personal interest paid or accrued by noncorporate taxpayers during the taxable year. Section 163(h)(2) defines the term "personal interest" as any interest allowable as a deduction for income tax purposes other than:

(i) Interest paid or accrued on debt connected with the conduct of a trade or business (but excluding debt incurred while performing services as an employee);

(ii) Any §163(d) investment interest;

(iii) Any interest taken into account under the new §469 passive loss limits;

(iv) Any "qualified residence interest"; and

(v) Interest payable on estate tax deferred under §§6163 or 6166.

As noted above, the types of interest which will be disallowed under the foregoing include interest on debt incurred by an employee to purchase items such as a car or computer and interest that accrues on a tax deficiency. Excluded, however, are any interest subject to the revised §163(d) investment interest limits, any interest taken into account under the passive loss rules of §469, and any "qualified residence interest." Of these, the exclusion of "qualified residence interest" and the inclusion of interest on tax deficiencies will be of most interest to individual taxpayers.

1. Qualified Residence Interest Defined

Section 163(h)(3) defines "qualified residence interest" as interest paid or accrued during the taxable year on debt secured by a "qualified residence of the taxpayer (*i.e.*, the taxpayer's principal residence or second home) at the time the interest is paid or accrued. Under §163(h)(5), the second home is the residence designated by the taxpayer for the taxable year that it is used by the taxpayer or family member for personal purposes for the greater of (i) 14 days, or (ii) 10% of the number of days during the year for which the home is rented at a fair rental.[46] However, a second home may be treated as a qualified residence for the taxable year regardless of the lack of personal use if it is neither rented nor used as a residence at any time during the taxable year.[47]

Under §163(h)(3), qualified residence interest will not include any interest on debt secured by the residence to the extent the debt exceeds the lesser of:

(i) The fair market value of the residence; or

(ii) The sum of (a) the taxpayer's purchase price for the residence, (b) the cost of improvements, (c) the taxpayer's qualified medical expenses, and (d) the taxpayer's qualified educational expenses.

For purposes of clause (ii) above, the taxpayer's purchase price for the residence will be treated as not less than the outstanding aggregate principal amount of debt which was incurred on or before August 16, 1986, and which was secured by the qualified residence on August 16, 1986.[48]

Except as provided in regulations, the residence interest limitation is determined only as of the time the debt is incurred.[49] Thus, for example, if a residence that secures the debt declines in value after the debt is incurred, interest will not be disallowed as personal interest even if the value of the residence after the decline is less than the outstanding balance of the debt.

Under §163(h)(4)(B), qualified medical expenses are amounts incurred for medical care (within the meaning of §213(d)(1)(A), (B)) of the taxpayer, his spouse and dependents. However, insurance premiums as well as medical expenses that would be covered by insurance or otherwise do not constitute qualified medical expenses.

Qualified educational expenses are amounts paid for tuition and related expenses of the taxpayer, his spouse or dependents, as well as amounts paid for reasonable living expenses while away from home, while a student at a educational organization described in §170(b)(1).[50]

Qualified educational expenses and qualified medical expenses must be incurred within a reasonable period of time before or after the debt is incurred for the interest on the debt to be deductible as qualified residence interest.

Note that, for purposes of the revised alternative minimum tax for tax years beginning after 1986, the amount deductible under the residence limitation may be sharply reduced. Revised §§56(b)(1)(C) and (e) allow the deduction of interest only on debt incurred to acquire, construct or substantially rehabilitate the principal residence and second home. Interest on refinanced home debt is deductible only to the extent the refinanced debt does not exceed the amount of the refinanced indebtedness immediately before the refinancing.

2. Secured Debt Requirement; Cooperatives

Interest on debt, whether used for home improvements or qualified medical or educational expenses, will not be deductible unless the debt is secured by the taxpayer's principal residence or second home. The fact that state

[45] For an example of the interaction between the phase-in rules under the passive loss rules and the reduction in the taxpayer's net investment income under §163(d), *see* Conference Report at II-157, footnote 7.

[46] *See* Code §§163(h)(5) and 280A(d)(1).

[47] §163(h)(5)(A)(iii).

[48] §163(h)(3)(C).

[49] §16 3(h)(3)(D).

[50] §163(h)(4)(C).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

homestead laws may restrict the rights of secured parties with respect to certain types of residential mortgages will not cause interest on the debt to be treated as nondeductible personal interest so long as the secured party's interest is perfected and the interest on the debt is otherwise qualified residence interest.[51]

Under §163(h)(5)(B), debt that is secured by housing cooperative stock held by a taxpayer as a tenant-stockholder (as defined in §216) is treated, for these purposes, as secured by the residence if the taxpayer is entitled to occupy the cooperative unit as a tenant-stockholder. If the stock may not be used as security by virtue of state or local law restrictions or pursuant to reasonable restrictions in the cooperative agreement, the stock may be treated as securing the debt if the taxpayer satisfies the Service that the debt was incurred to acquire the stock.

3. Interest on Deficiencies

As noted above, the interest on tax deficiencies is not deductible under the 1986 Act so any noncorporate taxpayer involved in an administrative or judicial proceeding involving prior tax shelter liabilities should consider paying the tax, and the interest thereon, and contesting the deficiency either in the Claims Court or the U.S. District Court rather than the Tax Court.

Rev. Proc. 84-58 [52] generally describes the rules for paying all or part of the tax and the interest on outstanding deficiencies without depriving the Tax Court of jurisdiction. Rev. Proc. 84-58 distinguishes between deposits made by taxpayers in the nature of "payments" and deposits in the nature of a "cash bond." Both stop the accrual of interest, but only a "payment" may be specifically allocated by the taxpayer to interest.

On October 23, 1986, the IRS issued a IR 86-144 and Ann. 86-108 [53] in which it interpreted and expanded upon the formal advice given in Rev. Proc. 84-58. The announcement was designed to provide guidance to taxpayers who wished to pay all or a portion of the interest accruing on outstanding deficiencies prior to the end of 1986, the last year for which an interest deduction thereon would be available (subject to the phase-in rules, discussed below). The announcement permits the taxpayer, in 1986, to designate that a portion of his payment be applied to interest in certain carefully delineated circumstances.[54]

4. Effective Date

The amendments to §163(h) disallowing the deduction of personal interest applies to taxable years beginning after December 31, 1986. However, as with investment interest, an "applicable percentage" of the taxpayer's personal interest will be deductible for taxable years beginning in 1987 through 1990.[55]

[51] Conference Report at II-156.
[52] 1984-2 C.B. 501.
[53] 1986-45 I.R.B. 20.
[54] *See* Struntz, "IRS Lays Out Procedure for Pre-87 Interest Pre-Payments," 65 J. Tax. 378 (Dec. 1986).
[55] §163(h)(6), cross referencing to §163(d)(6)(B) phase in rules for investment interest, discussed in II, A, 7 above.

C. Example

An example of the interaction between the passive loss rules, the investment interest limitation, the personal interest disallowance and other related provisions under the 1986 Act in a case in which a taxpayer owns a vacation home, subject to a mortgage, which is used partly for personal purposes and partly for business (rented) use follows:

(1) First, the taxpayer must determine the number of days of personal, as opposed to rental, use of the dwelling under §280A. Expenses (other than interest and taxes otherwise allowable) would then be allocated to each type of use, and disallowed to the extent attributable to personal use.[56]

(2) Next, the taxpayer must determine whether the dwelling meets the definition of a "residence" within the meaning of §280A(d)(1) and, thus whether the interest on the mortgage is "qualified residence interest" within the meaning of §163(d)(3)(B)(i), §163(h)(3) and§469(j)(7). Such definition will be met if the taxpayer, during the taxable year, uses the dwelling unit for personal purposes for the greater of (i) 14 days or (ii) 10% of the number of days during the taxable year that the dwelling is rented at a fair rental. If the dwelling is a "qualified residence":

(A) The passive activity loss (if any) of the taxpayer shall be determined without regard to the "qualified residence interest" attributable to the unit;[57]

(B) The investment interest limitation will not apply;[58]

(C) The rules governing the disallowance of a deduction for personal interest will not apply;[59] and

(D) The dwelling will qualify as a "residence" for purposes of §280A, and any deductions attributable to the fair rental of the unit (after deducting interest and taxes otherwise allowable) may not exceed the gross income derived from the fair rental of the unit for the taxable year.

Note: In addition to the foregoing, under the 1986 Act, the taxpayer's losses, if any, from rental of the unit may be deducted only to the extent that the taxpayer is "at risk" with respect to the activity.[60] In general, a taxpayer's "at risk" with respect to an activity to the extent of (i) the amount of money or property contributed, (ii) the amount of financing for which he is personally liable, and (iii) the amount of certain "qualified nonrecourse financing."

(3) If the dwelling does not meet the definition of "qualified residence" (whether or not the taxpayer materially participates in the rental activity:

(A) Any losses of the taxpayer (determined by taking into account the mortgage interest on the

[56] *See* Senate Report at 807; §280A(e)(1).
[57] §469(j)(7).
[58] §163(d)(3)(B)(i).
[59] §163(h)(2)(D).
[60] §465(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

unit) with respect to the rental of the unit will be subject to the passive loss rules, *except that*, if the taxpayer "actively participates" with respect to the rental activity (a standard requiring less personal involvement than material participation) he may deduct up to $25,000 (phased-out by 50% of the amount by which gross income exceeds $100,000) of the passive activity loss with respect to the activity;[61]

(B) Since the passive loss rules apply, the investment interest limitations will not apply.[62] This apparently is the case even where a portion of the passive activity loss is allowed under §469(i) by reason of the taxpayer's active participation in the activity;[63]

(C) That portion of the interest on the mortgage on the dwelling which is attributable to personal use arguably will be disallowed.[64] This is suggested by an example in the Senate Report [65] in which interest is first allocated to business use and personal use under §280A, and then that portion which is allocated to business, *i.e.*, rental, use would thereafter be tested under the rules applicable to investment interest under §163(d). In the final version of the 1986 Act, however, any rental activity was made subject to the passive loss rules,[66] thus removing it from the scope of both the investment interest limitation [67] and the personal interest disallowance.[68] It is unclear, however, under the passive loss rules, how interest (which is not qualified residence interest) is allocated between personal and business use in the case, *e.g.*, of a vacation home. If all of the interest thereon is treated as a passive activity expense, the effect may be to convert otherwise nondeductible personal interest to interest which is deductible, under the passive loss rules, to the extent of passive income.

(D) Although the expenses of the dwelling which are attributable to the rental of the unit may exceed the gross rental income from the unit under §280A, the deduction of the losses may be limited both by the passive loss rules and by the "hobby loss" provisions of §183.[69]

D. Miscellaneous Related Provisions

1. Amortizable Bond Premium Treated as Interest

Section 643 of the Tax Reform Act of 1986 amends §171(e) (relating to deduction of amortizable bond premium) to provide that, except as provided in regulations, the amount of any amortizable bond premium deductible under §171(a)(1) for any taxable year, shall be treated as interest for all purposes, including the investment interest limitations. This amendment generally applies to obligations acquired after October 22, 1986, in taxable years ending after such date.

2. Capitalization of Interest

Section 803 of the Tax Reform Act of 1986 adds new §263A to the Code which requires the capitalization of interest with respect to the production or construction of certain property, including all real property and all tangible personal property produced by the taxpayer which has (i) a class life of 20 years or more, (ii) an estimated production period exceeding two years, or (iii) an estimated production period exceeding one year and a cost exceeding $1,000,000. Capitalization is not required for personal use property. Under pre-1986 TRA law (§189), capitalized construction interest was amortizable over ten years instead of becoming a part of the basis of the asset. The amendment applies, with exceptions, to costs incurred after December 31, 1986, in taxable years ending after that date. However, property produced by the taxpayer for us by the taxpayer with respect to which substantial construction occurred prior to March 1, 1986 are grandfathered.[70]

In addition, under new Code §460(c)(3), taxpayers producing property under a long-term contract must capitalize interest costs to the extent income is not reported under the percentage of completion method. Conference Report at II-308-09. This amendment applies generally to contracts entered into after February 28, 1986.

3. Denial of Deduction for Interest on Loans From Certain Life Insurance Contracts

Act §1003 adds new §264(a)(4) (relating to the disallowance of a deduction for certain amounts paid in connection with insurance contracts) to provide that any interest paid or accrued on any indebtedness with respect to one or more life insurance policies owned by the taxpayer on the life of certain key employees and owners is disallowed to the extent that the total of the loans to such employees or owner exceeds $50,000.

In determining the total loans outstanding with respect to any one person, the $50,000 of permitted borrowings by the taxpayer with respect to life insurance covering that person is determined by aggregating all policies covering his life with respect to which the taxpayer has borrowed, even if these policies are held by more than one trade or business or more than one member of an affiliated group of the taxpayer.[71] The Conference Report further clarifies that the nondeductibility of interest on loans in excess of $50,000 is not affected by whether or not the proceeds of the loan are used in the trade or business of the taxpayer.[72]

The amendment to §264(a) is effective for contracts purchased after June 20, 1986 in taxable years ending after that date.

4. Alternative Minimum Tax Itemized Deductions

The Tax Reform Act of 1986 (§701) substantially revises the rules with respect to the computation of alterna-

[61] §469(i).
[62] §163(d)(3)(B)(ii).
[63] *See* Conference Report II-153.
[64] §163(h)(1).*But see* §163(h)(2)(C) which removes from the definition of "personal interest," any interest subject to the passive loss rules.
[65] Senate Report at 807.
[66] §469(c)(2).
[67] §163(d)(4)(D).
[68] §163(h)(2)(D).
[69] *Cf.* §280A(d)(3).
[70] Act §803(d)(1) and (3).
[71] Conference Report Conference Report at II-341.
[72] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tive minimum taxable income, including changes in the treatment of alternative tax itemized deductions, such as qualified interest expense. Under the Act, the definition of net investment income is conformed to the defintion adopted under §163(d) for regular tax purposes (although determined with regard to minimum tax items of income and deduction), and any investment interest deductions that are disallowed may be carried over.

Specifically, new Code §56(b)(1)(C) provides that, in determining the amount of interest allowable as an alternative minimum tax itemized deduction with respect to individuals, the investment and personal interest limitations of §163(d) and (h) shall apply with the following exceptions:

(i) Deductible personal interest includes "qualified housing interest" (as defined in §56(e)) instead of "qualified residence interest" (as defined in §163(h)(2)(D)). (*See* discussion, above.)

(ii) The phase-in periods under §163(d)(6) and §163(h)(6) do not apply for purposes of the alternative minimum tax. Therefore, during the four-year phase-in period, the amount of investment and personal interest deductible for minimum tax purposes will be less than that deductible for regular tax purposes; and

(iii) Interest on certain specified private activity bonds (generally those issued after August 1, 1986) will be treated as both includible in gross income and deductible under §163(d).

The minimum tax amendments apply generally to taxable years beginning after December 31, 1986.[73]

For another discussion of the 1986 changes, *see* Weiner, "A Few Matters of 'Interest' under the Tax Reform Act of 1986," 2 Tax Mgmt. Real Est. J. 270 (Dec. 1986).

---

[73] Act §701(f)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 6

DEDUCTION FOR MEALS, TRAVEL AND ENTERTAINMENT EXPENSES MODIFIED [ACT §142]

John Freeman Blake, Esq.
Silverstein and Mullens
Washington, D.C.

I. Overview

In its effort to restrict deductions in exchange for lower tax rates, the Tax Reform Act of 1986 makes major changes to the deduction available for business meals, travel and entertainment expenses. Several new restrictions are enacted for the deduction of business meals. First, the deduction for meals is generally cut back to 80% of the dollars expended for the business meal. Second, the substantiation requirements for business meals is stiffened. Third, in order for a deduction for a business meal to be taken, the taxpayer or his representative must be present at the meal.

The deduction for entertainment expenses are also restricted in a number of ways. First, the deduction is generally limited to 80% of the expense. Second, the deduction is limited to the cost to the taxpayer, unless the entertainment is connected with a charitable fund raising event. Third, deductions for the rental skyboxes at sporting events and facilities are limited to the cost of the highest price ticket available to the general public.

The deduction for travel expenses is also restricted in a number of ways. First, so-called "luxury water travel" is deductible only to the extent of the federal per diem available to federal employees. Second, travel as a form of education is no longer deductible. Third, travel for charitable purposes is not deductible unless there is no significant element of pleasure associated with the travel.

Finally, a new rule eliminates the deduction under §212 for the costs of attending a convention. This new rule affects taxpayers who deducted these costs as an expense incurred in the production of investment income, but does not affect taxpayers who deduct these costs as an expense incurred in the active conduct of a trade or business under §162.

II. Pre-TRA 1986 Law

Code §162 allows a deduction for ordinary and necessary business expenses. Code §212 allows similar deductions for expenses incurred in the production of investment income. In order for an activity to be deductible under either §162 or §212, the taxpayer must establish a business purpose for the expense. In the case of meals, the taxpayer must show that the business meal was conducive to the carrying on of the taxpayer's business or investment activities. In the case of other entertainment expenses and travel expenses, Code §274 requires the taxpayer to establish that, in addition to constituting ordinary and necessary business expenses, they are either directly related to the active conduct of the taxpayer's business, or, if directly preceding or following a substantial and bona fide business discussion, associated with the active conduct of the taxpayer's business.[1]

No deduction is allowed for personal, family, or living expenses, or for otherwise deductible expenses (including meals) to the extent that the expenses are lavish and extravagant under the circumstances.[2]

Section 274 also sets forth certain substantiation requirements for business expense deductions, which, if not met, result in the disallowance of a claimed deduction. The substantiation requirements of §274(d) must be met as a condition for deductibility of the following types of expenses:

(1) traveling expenses (including meals and lodging while away from home);[3]

(2) entertainment expenses, amusement expenses, or expenses for recreation activities or facilities expenses with respect to entertainment;

(3) business gifts; and

(4) expenses relating to luxury automobiles and other so-called listed property which is used for both personal and business activities (as defined in §280F(d)(4)).[4]

To deduct these expenses, §274(d) requires that the taxpayer must substantiate the following facts by adequate records, or sufficient evidence corroborating the taxpayer's statement:

(1) the amount of the expense or item;

(2) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift;

(3) the business purpose of the expense or other item; and

(4) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift.

---

[1] Code §274(a)(1). For all purposes under §274, expenses incurred for the production of investment income (§212 expenses) are treated as if they had been incurred in the active conduct of a trade or business (§162 expenses).

[2] *See* §162(a)(2).

[3] Note that business meals are not subject to the substantiation requirements of §274 unless the meal is consumed while traveling away from home.

[4] §274(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

To meet the adequate records standard under Regs. §1.274-5(c), documentary evidence (such as receipts or paid bills) is required for any expenditure of $25 or more (except certain transportation charges).

No deduction or credit generally is allowed for the cost of purchasing or constructing entertainment facilities known as skyboxes (*see* §274(a)(1)(B)).

Travel expenses, other than lavish and extravagant expenditures for meals or lodging, incurred by a taxpayer while away from home in the conduct of a trade or business generally are deductible if substantiated pursuant to §274. No special rules limit otherwise allowable deductions for the costs of luxury water transportation. However, limitations do apply to cruise ship conventions,[5] and to foreign conventions.[6]

In the case of educational travel, traveling expenses may be deductible as business expenses if the taxpayer establishes that the travel (1) directly maintains or improves existing employment skills, and (2) directly relates to the taxpayer's duties in his or her employment or trade or business, and if the taxpayer substantiates the expenses as required by §274. No deduction is allowable unless the travel is undertaken primarily to obtain education. In addition, even if the travel meets this primary purpose test, no deduction is allowed for expenses allocable to personal activity incidental to the primary business activity (*see* H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-29 (1986) ("Conference Report")).

Traveling expenses away from home may also give rise to a charitable deduction if the taxpayer establishes that the travel expenses (whether paid directly by the individual or indirectly through a contribution by the individual to the charity, which then pays for the individual's travel) are incurred in rendering services to a qualified charitable organization, and if the taxpayer substantiates the expenses as required by §170(a)(1) and the regulations (*see* Conference Report, p. II-29).

The costs of attending a convention or seminar incurred in carrying on a trade or business are deductible under §162, subject to substantiation requirements of §274. However, no deduction is allowed for the cost of attending a convention outside of the North American area (*i.e.*, not in the United States, Canada, Mexico, or certain Caribbean countries) unless the taxpayer can show that it was as reasonable to hold the convention there as in the North American areas.[7] Certain Caribbean countries, including Bermuda, are treated as in the North American area if they make available certain tax information to U.S. authorities and if other specified requirements are met.

III. Changes made by the Tax Reform Act of 1986

A. Meal Expenses

Act §142 retains the deduction for business meals, but stiffens the substantiation requirements, imposes a new requirement that the taxpayer be present at the meal in order to deduct it, and reduces the deduction to 80% of the amount expended.

The 80% limitation is contained in new Code §274(n) and applies to both meal and entertainment expenses. The cutback for meals generally applies to all meal expenses, including meals away from home and meals furnished on an employer's premises to its employees (whether or not the meals are excludable from the employee's gross income under §119).

New Code §274(n)(2) provides for certain exceptions to the 80% limitation. Meals which fall within one of the following exceptions are fully deductible by the taxpayer:

(1) reimbursed meal expenses (in which case the employer or person making the reimbursement is subject to the 80% rule);

(2) employer-furnished meals that are excludable from the employee's gross income as *de minimis* fringes under Code §132(e) (including meals at certain eating facilities excludable under §132(e)(2));

(3) meals fully taxed to the recipient as compensation; and

(4) items sold to the public (such as expenses incurred by restaurants or dinner theaters for food or entertainment provided to their customers), or furnished to the public as samples or for promotion (such as expenses incurred by a hotel in furnishing complimentary lodging to potential customers).

According to the conference agreement accompanying the Act, a restaurant or catering firm may deduct 100% (rather than 80%) of its costs for food and beverage items, purchased in connection with preparing and providing meals to its paying customers, even though some portion of the items are consumed at the work site by employees of the restaurant or caterer.[8]

The Act also toughens the substantiation requirements applicable to business meals by providing that the deduction for meals is subject to the same business-connection requirement as applies under present law for other entertainment expenses. The Conference Report, p. II-26, states that a food or beverage expense, therefore, is not deductible unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that the item was associated with the active conduct of the taxpayer's trade or business. Under this standard, no deduction is allowed unless business is discussed during, or directly before or after, the meal (except where a taxpayer is traveling away from home on business has a meal alone or with persons, such as family members, who are not business-connected, and a deduction is claimed only for the meal of the taxpayer).

In addition to the present-law rule contained in §162(a)(2) which disallows deductions for travel expenses (including meals) to the extent that they are deemed to be

[5] *See* Code §274(h)(2)
[6] *See* Code §274(c).
[7] *See* §274(h).
[8] *See* Conf. Rep., p. II-25.

lavish and extravagant, the Act contains a separate statutory prohibition specifically for lavish or extravagant business meals. This new disallowance rule applies whether or not the expense is incurred while the taxpayer is away from home, and whether the taxpayer incurs the expense alone or with others. New code §274(k)(1)(A) provides that no deduction is allowed for any food or beverage expense *unless* the expense is *not* lavish or extravagant under the circumstances. The wording of this disallowance rule differs from that contained in §162(a)(2), and appears on its face to be more restrictive than the current rule. Under the statutory language of new Code §274(k)(1)(A), if a meal is deemed to have been lavish or extravagant under the circumstances, the entire expense may be disallowed. This result would not occur under §162(a)(2), which disallows an expense only *to the extent* that it is deemed to have been lavish or extravagant.

While the statutory language of new §274(k)(1)(A) appears to disallow the entire expense if any portion is deemed to have been lavish or extravagant, it is not clear that this was the legislative intent of the new section. The conference agreement that accompanies the Act explains the interrelationship of the 80% limitation and the lavish and extravagant rule with the following example:

Example: Since the 80% reduction rule is applied only after determining the otherwise allowable deduction under §§162 and 274, if a taxpayer incurs otherwise deductible business lunch expenses of (for example) $80 for himself and if $30 of that amount is not allowable as lavish or extravagant, the remaining $50 is then reduced by 20%, leaving a deduction of $40.[9]

The language of new §274(k)(1)(A) comes directly from the House-passed version of the Act.[10] In addition, both the House Ways and Means Committee Report and the Senate Finance Committee Report accompanying each house's version of the Act contained the same example as was contained in the conference agreement.[11] Based upon this legislative history, it is clear that the various legislative staffs had in mind a disallowance similar in nature to that contained in §162(a)(2), which would disallow an expense only *to the extent* that the expense was lavish or extravagant.

Finally, to further curb the deduction for meals, new Code §274(k)(1)(B) provides that no deduction for food or beverage expenses is allowed unless the taxpayer or an employee of the taxpayer is present at the furnishing of the food or beverages (except where a taxpayer is traveling away from home on business has a meal alone or with persons, such as family members, who are not business-connected, and a deduction is claimed only for the meal of the taxpayer). For purposes of this rule, an independent contractor who renders significant services to the taxpayer (such as an attorney representing the taxpayer in a legal proceeding) is treated as an employee if he or she attends the meal in connection with the performance of the services.[12]

The Act includes a special exception to the 80% deductibility rule applicable during the calendar years 1987 and 1988 for costs for meals that are provided as an integral part of a qualified banquet meeting. A qualified banquet meeting is a convention, seminar, annual meeting, or similar business meeting (including meetings held at an employee training facility) if the following conditions are met: (1) the program includes the meal, (2) more than 50% of the participants are away from home, (3) there are at least 40 attendees, and (4) the meal event includes a speaker.[13]

B. Business Entertainment

Act §142(b), enacting new Code §274(n) reduces to 80% the amount of deduction otherwise allowable for business entertainment expenses. New Code §274(n)(2) provides exceptions allowing full deductibility for the following entertainment expenses:

(1) reimbursed entertainment expenses (in which case the employer or person making the reimbursement is subject to the 80% rule);

(2) traditional employer-paid recreational expenses for employees (*e.g.*, a holiday party);

(3) items fully taxed to the recipient as compensation, or excludable from income as §132(e) *de minimis* fringe benefits;

(4) items sold to or made available to the general public (*e.g.*, as promotional activities); and

(5) tickets and related expenses at certain charitable fund raising sports events.

In addition, under new Code §274(l)(1)(A), no amount of ticket costs in excess of the face value of the ticket is deductible, except in the case of tickets for certain charitable fund raising sports events.[14] According to the conference agreement accompanying the Act, the limitation to the face value amount applies prior to application of the 80% rule.[15]

Apart from the generally applicable entertainment facility rules, the Act disallows deductions for costs of rental or other use of a skybox or other private luxury box ("skybox") at a sports arena (to the extent the deductions are in excess of the cost of regular box seat tickets) by the taxpayer or a related party for more than one event (as determined taking into account all skybox rentals by the taxpayer in the same arena, along with any related rentals).[16] The skybox deduction disallowance rule is phased in over three years. The amounts disallowed for taxable years beginning in 1987 and 1988 are, respectively, one-third and two-thirds of the amounts that otherwise would be disallowed under the Act if the provision were fully effective in those years.[17]

Notwithstanding this disallowance rule, two types of expenses related to a skybox still may be deductible, subject to the 80% rule, if they meet the generally applicable requirements for deducting business entertainment ex-

[9] *Ibid.*
[10] *Cf.* H.R. 3838 as passed by the House, §142(a)
[11] *Cf.* House Ways and Means Committee Rep. 426, 99th Cong., 1st Sess., pp. 123-124 (1985); Senate Finance Committee Rep. 313, 99th Cong., 2d Sess., p. 71 (1986).
[12] Conf. Rep., p. II-26.
[13] *See* Act §142(b) enacting new Code §274(n)(2)(D) and (3).
[14] *See* new Code §274(l)(1)(B), as enacted by Act §142(b).
[15] *See* Conf. Rep., p. II-28.
[16] *See* new Code §274(l)(2)(A).
[17] *See* new Code §274(l)(2)(B).

penses. First, an amount not exceeding the face values of the highest-priced nonluxury box seats generally held for sale to the public on an event-by-event basis, multiplied by the number of seats in the skybox, is deductible. For example, if a category of box seats represents the highest-priced seats available (other than in skyboxes) and is offered to the public on a first-come, first-served basis, the face value of such box seat may be used in the deduction computation. On the other hand, the price of a limited number of seats that generally are made available by management only to a select group of purchasers (and not offered to the public generally) cannot be used in computing the allowable deduction for the skybox seats. Second, the deductibility of separately stated charges for food or beverages is determined under the rules generally applying to business meals (described above), including the percentage reduction rule and the disallowance of lavish or extravagant expenditures.[18]

C. Travel Expenses for Business, Education and Charitable Activities

The Act restricts the deduction for travel on luxury water transportation. Under new Code §274(m), the amount of any otherwise allowable deduction for the costs of a cruise ship or other luxury water transportation is limited to twice the highest federal per diem for travel in the United States, times the number of days in transit. This limitation does not apply with respect to expenses of cruise ship conventions, which remain subject to present-law limitations (§274(h)(2)), or where an exception to the 80% deduction rule applies.

The Act also restricts deductions for educational travel. Under new Code §274(m)(2), no deduction is allowed for costs of travel that would be deductible only on the ground that the travel itself constitutes a form of education. This provision overrules Regs. §1.162-5(d) to the extent that the regulation allows deductions for travel as a form of education. To explain the extent of this limitation, the Conference Report gives as examples of non-deductible travel the situations where a teacher of French travels to France to maintain general familiarity with the French language and culture, or where a social studies teacher travels to another state to learn about or photograph its people, customs and geography.[19] However, it would appear that if a person employed as a researcher travels to France for the specific purpose of reviewing documents not elsewhere available, the deduction would continue to be allowed.

The present-law rule applicable to medical deductions for lodging costs away from home (§213(d)(2)(B)) is extended to charitable deductions claimed for transportation and other travel expenses incurred in performing services away from home on behalf of a qualified charitable organization.[20] Under this rule, no deduction is allowed for travel expenses incurred in connection with work performed for a charity unless there is no significant element of personal pleasure, recreation, or vacation in the travel away from home. This is true whether the expense is paid directly by the individual or indirectly through a contribution to the organization. As under present law, an otherwise qualifying charitable deduction is deductible only if properly verified, and no charitable deduction is allowable for a contribution of services to a charitable organization.

D. Travel Expenses for Attending Conventions

The Act prohibits deductions for the costs of attending conventions which have been deductible as an expense incurred in the production of investment income under Code §212. Act §142(c) amends Code §274(h)(7) and provides that no deduction is allowed under §212 for travel or other costs of attending a convention, seminar, or similar meeting. Thus, registration fees, travel and transportation costs, meals, lodging expenses and other similar expenses incurred in connection with attending a convention, seminar, or similar meeting relating to investments, financial planning, or other income-production or §212 activities are not deductible. This disallowance rule does not apply to expenses incurred by a taxpayer in attending a convention, seminar, sales meeting, or similar meeting relating to the active conduct of a taxpayer's trade or business (within the meaning of §162).

IV. Effective Date

The changes made by Act §142 are effective for taxable years beginning after December 31, 1986.[21]

[18] *See* new Code §274(l)(2)(A) and Conf. Rep., p. II-29, fn. 4.

[19] *See* Conf. Rep., p. II-30.

[20] Act §142(d), enacting new Code §170(k).

[21] Act §151(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 7

MODIFICATION OF SPECIAL INDUSTRY DEDUCTIONS

Jane M. Eldredge, Esq.
Lucia N. Smeal, Esq.
Silverstein and Mullens
Washington, D.C.

I. Limitation on Expensing of Soil and Water Conservation Expenditures

A. Introduction

A taxpayer may elect to expense (currently deduct) certain soil and water conservation expenses, pursuant to §175 of the Code, that would otherwise be added to the basis of the land on which the conservation action occurs. The deductible conservation expenses include costs of grading, terracing and contour furrowing, the construction of drainage and irrigation ditches, dams and ponds, the planting of wind breaks, and the eradication of brush.

In any one taxable year, a taxpayer may not deduct more than 25% of his gross income derived from farming. Any excess costs must be carried forward to succeeding taxable years.[1]

B. Detailed Analysis

1. New Conservation Plan Requirement

The Tax Reform Act of 1986 ("the Act") retains the taxpayer's option to elect to currently deduct expenditures incurred for the purpose of soil or water conservation. However, §401 of the Act adds new §175(c)(3) to limit the deduction's availability to those expenses incurred pursuant to a conservation plan approved by the Soil Conservation Service of the U.S. Department of Agriculture or a comparable state agency.

The Conference Committee Report[2] clarifies that an individual taxpayer's specific project does not require prior approval by a state or federal agency in order for the expenditures to qualify for the deduction; but, that an overall conservation plan which includes the taxpayer's land must be in effect at some time during the taxable year in which the taxpayer takes the deduction for conservation expenses.

2. Deductions for Expenditures on Wetlands and Center Pivot Irrigation System Repealed

New §175(c)(3)(B) specifies that deductions will no longer be available for expenditures incurred during the draining or filling of wetlands. Neither will a taxpayer be able to expense the costs of preparation of the land or the costs of the installation or operation of a center pivot irrigation system.[3]

The rationale expressed in the Report of the Senate Finance Committee[4] is that the availability of deductions for these expenses may have encouraged the present overproduction of agricultural products. The Senate Committee stated that it desired to "eliminate tax biases" in agricultural business decisions.[5]

C. Effective Date

These limitations are effective for expenditures made after December 31, 1986.

II. Repeal of Land Clearing Expense Deduction

Section 402 of the Act repealed the former election under §182 to expense the costs incurred in clearing land to make it suitable for farming. This repeal is a result of Congressional concern that too much land is going into agriculture for tax rather than prudent business reasons.[6] The Senate Committee Report clarified that the repeal of §182 does not repeal the deductibility of ordinary and necessary brush clearing or other expenses under §1672 which are necessary for maintenance of farm ground. It only repeals the deduction for brush clearing necessary to first use the land for agricultural purposes.

The repeal of the deduction is retroactive. It is effective for expenditures made after December 31, 1985.

III. Limitation on Certain Prepaid Farming Expenses

A. Introduction

Deductions allowed to be taken by farming syndicates had been limited even before the Tax Reform Act of 1986. Section 464(c) of the Code defines a farming syndicate as a partnership or corporation which is not an S corporation, engaged in the trade or business of farming, which either has shares or other interests which have been treated as if they were registered securities, or in which more than 35% of the losses are allocable to limited partners.

---

[1] Code §175(b).
[2] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-109 (1986) ("Conference Report").
[3] Act §401.
[4] S. Rep. No. 313, 99th Cong., 2d Sess. 265 ("Senate Report").
[5] *Ibid.*
[6] *Ibid.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

If a farming operation is classified as a farming syndication, a deduction is allowed for feed, seed, fertilizer or other farm supplies only in the taxable year in which those items are consumed, regardless of whether the taxpayer uses a cash basis or accrual method of accounting.

B. Detailed Analysis

The Act extends these farming syndicate limitations to certain other farming expenses. The Senate Finance Committee was concerned about the use of farming tax shelters by syndicators and others to create prepaid farming expenses in order to defer or escape taxation of nonfarm income.[7] Therefore, §404 of the Act limits deductions for "certain prepaid farming expenses." In general, a farmer using the cash method of accounting may not deduct prepaid farming expenses that exceed 50% of the deductible farming expenses (excluding prepaid farming expenses) for that taxable year.

Section 404 of the Act adds new §464(f) to the Code. Section 464(f)(2) applies to any farmer who (i) does not use the accrual method of accounting; (ii) has "excess prepaid farm supplies;" and (iii) is not a "qualified farm-related taxpayer."

"Excess prepaid farm supplies" are defined at §464(f)(4) to describe the costs of feed, seed, fertilizer or other similar farm supplies paid for the taxable year in which they were used, which costs would be allowable as deductions in subsequent taxable years when the supplies were used, but only to the extent these prepaid amounts exceeded 50% of the deductible farming expenses excluding prepaid supplies. The prepaid costs which are greater than 50% of the ordinary and deductible farming expenses are in excess of the amount which may be deducted by the taxpayer.

If an individual is a "qualified farm-related" taxpayer, the additional limitations do not apply. Code §464(f)(3) defines a qualified farm-related taxpayer as a taxpayer (i) whose principal residence is on a farm; or (ii) whose principal occupation is farming; or (iii) who is a member of a family whose principal residence is on a farm or whose principal occupation is farming; and for whom the aggregate prepaid farm supplies for the three preceding tax years are less than 50% of the aggregate deductible farming expenses, excluding prepaid farm supplies, for the same three-year period.[8] If the prepaid expenses have not been excessive in the past three years, the taxpayer will not be penalized for a one-year deviation.[9]

The second exception to the 50% test occurs if the taxpayer has excess prepaid farm supplies because of a change in his business operation due to extraordinary circumstances. For instance, a fire which destroyed all of a farmer's feed may require excessive prepaid expenses to replenish.

C. Effective Date

Section 404 of the Act applies to the deduction of costs paid or incurred for farm supplies after March 1, 1986, in taxable years beginning after that date.[10]

[7] *Ibid*, at 268-269.
[8] §464(f)(3).
[9] Senate Report at 269.
[10] Act §404(c).

IV. Deduction for Intangible Drilling Costs and Mineral Exploration and Development Costs Modified

A. Introduction

Intangible drilling and development costs (IDCs) generally include expenditures for the preparation of wells for production and drilling for oil, gas or geothermal energy. IDCs include labor and material costs to clear and drain a well site, construct access roads, survey, build derricks or other necessary structures and to drill, shoot, fracture and clean the wells.[11] Prior to the TRA of 1986, persons holding an operating or working interest in an oil, gas or geothermal property could elect to expense (currently deduct) the costs of all IDCs or capitalize the costs and recover them through depletion or depreciation deductions.[12] Domestic and foreign IDCs were subject to the same tax rules. However, "integrated" producers (those who are also retailers or refiners) as defined in §291(b) of the Code could deduct only 80% of their IDCs. The remaining 20% of costs was required to be amortized over a 36-month period starting with the month in which the costs were paid or incurred.[13] All of the expenses for a nonproductive well, or "dry hole," could be expensed in the year the dry hole was completed.[14]

Mineral exploration and development costs include the costs of determining the existence, location, extent, quality of a mineral deposit and costs of constructing, preparing or drilling a mine for production. Prior to the TRA of 1986, a taxpayer could elect to expense or capitalize those costs regardless of whether they were domestic or foreign. The only limitations on the expensing of the costs applied to corporate taxpayers, who were required to capitalize 20% of the exploration and development costs using the schedule for 5-year accelerated cost recovery system (ACRS).

B. Overview and Analysis

1. Intangible Drilling Costs

a. General Rule

Under the TRA of 1986, taxpayers with operating or working interests in a well may still elect to expense the intangible drilling and development costs incurred in connection with the domestic production of oil, gas or geothermal properties. Foreign IDCs are treated differently because of the depressed oil industry in the United States and the strong competition from foreign markets.[15]

b. Integrated Producers

The percentage of domestic IDCs of "integrated producers" that may be expensed is reduced under the Act from 80% to 70% of total IDCs. The remaining 30% of costs must be amortized ratably over a 60-month (5-year) period starting with the month in which the costs are incurred or paid.[16] Integrated producers may still expense

[11] Regs. §1.612-4.
[12] Code §263(c).
[13] Pre-TRA Code §291(b)(2).
[14] Conference Report at II-119.
[15] H.R. Rep. No. 426, 99th Cong., 1st Sess. 201-202 (1985) ("House Report").
[16] Code §291(b)(1) and (2), as amended by Act §411(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the costs of a dry hole in the year in which the dry hole is completed.[17]

c. Foreign IDCs

Under Code §263(i) as added by Act §411(b), all IDCs incurred outside of the United States, at the election of the operator, may be: (i) amortized over a 10-year straight-line amortization schedule; or (ii) recovered as part of the basis through cost depletion.

The election to currently deduct all expenses of a foreign dry hole in the year the dry hole is completed is not changed by TRA 1986.

d. Exception to Foreign IDC Treatment

The changes to the treatment of foreign IDCs do not apply to IDCs incurred by domestic "companies pursuant to a minority interest in a license for Netherlands or United Kingdom North Sea development if such interest was acquired on or before December 31, 1985." [18]

2. Mineral Exploration and Development Costs

a. General Rule

The TRA of 1986 treats the taxation of oil, gas, geothermal and hard mineral production in a similar manner as a result of the currently depressed markets and the serious international competition among suppliers of these products.[19] Thus, the noncorporate taxpayer retains the option to currently deduct all exploration and development costs.

b. Corporation Rule Modified

Act §411 amends Code §291(b)(1) to require corporations to amortize 30%, rather than 20%, of their exploration and development costs. The amortization must be ratable over a 60-month period beginning in the month the costs are paid or incurred.

c. Foreign Exploration and Development Costs

Act §411(b) added a new §616(d) to provide that the exploration and development costs for minerals outside the United States are recovered at the taxpayer's election either: (i) over a 10-year straight-line amortization schedule; or (ii) as part of the basis for cost depletion.

C. *Effective Date*

The modification to the treatment of IDCs and mineral exploration and development costs is effective for costs paid or incurred after December 31, 1986.

V. Modification of Percentage Depletion Rules

A. *Introduction*

The pre-drilling costs of acquiring an oil or gas lease and the geological or geophysical costs incurred before any actual drilling occurs may be recovered either by the use of cost depletion or percentage depletion, whichever yields the larger deduction. The amount recovered under cost depletion cannot exceed the taxpayer's basis in the property. Under this method of depletion the taxpayer deducts the portion of the adjusted basis in the oil or gas property equal to the ratio of units of gas or oil sold from that property during the taxable year to the number of units at the beginning of the taxable year.

Percentage depletion allows the independent producer or royalty holder to deduct 15% of his gross income from an oil or gas producing property up to 50% of the net income from that property in any one taxable year.[20] All deductions for all oil and gas properties may not be greater than 65% of the taxpayer's overall taxable income.[21]

The Tax Reduction Act of 1975 added §613A to limit the availability of percentage depletion to independent producers and royalty owners. Percentage depletion was no longer available to "integrated producers," who are also retailers or refiners of oil or gas. In addition, percentage depletion was limited further. Independent producers could take percentage depletion for up to 1,000 barrels of average daily production of domestic crude oil or the equivalent in gas production.

For hard minerals, taxpayers may elect to use cost depletion or percentage depletion to recover acquisition and certain other related costs of mines and mineral deposits. Taxpayers must use whichever method produces the larger deduction.[22] Cost depletion reduces the adjusted basis of the mineral interest in a proportion equal to the ratio of the number of units sold from the property during the taxable year to the number of units at the beginning of the taxable year. On the other hand, percentage depletion is computed as a statutory percent of the taxpayer's gross income. The particular statutory percentage is set forth in §613(b) of the Code and varies from 5% to 22% depending on the type of mineral. There is no relationship between the statutory percentage and the taxpayer's basis in the property. If the taxpayer is a corporation, its percentage depletion of coal or iron ore, in excess of adjusted basis, is reduced by 15%.[23]

B. *Detailed Analysis*

1. Limitations of Percentage Depletion for Oil and Gas

After the 1975 Tax Reduction Act depletion amendments, it was not clear whether lease bonuses, advance royalties or other payments in advance of actual production from oil or gas properties were entitled to percentage depletion. In January 1984 the Supreme Court, in *Commissioner v. Engle*,[24] held that percentage depletion is available with respect to oil and gas lease bonuses or advance royalty payments. In June of 1984 the IRS announced the manner for determining the percentage depletion by recipients of bonuses and advance royalties.[25]

[17] Senate Report at 269.
[18] Act §411(c)(2).
[19] Senate Report at 282.
[20] Code §613A(c)(5).
[21] Code §613A(d).
[22] Conference Report at II-121.
[23] Code §291(a)(2).
[24] 464 U.S. 206 (1984).
[25] House Report at 206, which cites I.R. Ann. 84-59, 1984-23 I.R.B., June 4, 1984.

Section 412 of the Act added Code §613A(d)(5) and §613(e)(4) to deny the availability of percentage depletion for lease bonuses, advance royalties or other payments without regard to actual production of oil, gas or geothermal properties, thus reversing the *Engle* decision.

This limitation applies to all amounts received or accrued after August 16, 1986.

2. Modification of Corporate Preference Items Relating to Hard Minerals

Section 412 of the Act increases the amount of the reduction of the available percentage depletion deduction from 15% to 20%. This amendment to §291(a)(2) of the Code is effective for taxable years beginning after December 31, 1986.

3. Percentage Depletion Available for Royalty Income From Coal and Domestic Iron Ore

Section 311 of the Act repeals corporate capital gains treatment for income from coal and domestic iron ore royalties resulting in the availability of percentage depletion under §631(c) for these amounts. (See Chapter 34 of this TRA Portfolio.)

This change is effective for all taxable years beginning after December 31, 1986.

VI. Repeal of Amortization of Railroad Grading and Tunnel Bores

Under Code §185 prior to its amendment by TRA 1986, domestic common carriers could elect to amortize over 50 years the adjusted basis of land improvements for railroad grading and tunnel bores. Qualified railroad grading and tunnel bores include all improvements resulting from excavations, construction of embankments, clearings, diversions of roads and streams, tunneling, and sodding of slopes necessary to construct, reconstruct, alter, protect, improve, replace or restore a right-of-way for railroad track.[26]

The §185 election for 50-year amortization of qualified railroad grading and tunnel bores is repealed under §242 of TRA 1986. As a result, such expenditures must now be capitalized and recovered upon disposition of the asset.

In general, repeal is effective for the portion of the basis of property attributable to expenses paid or incurred on or after January 1, 1987, the general effective date of the Act.[27] However, limited transition rules are provided. The election is still available for costs incurred pursuant to a binding contract entered into before March 2, 1986.[28] In addition, the election will still be permitted for costs incurred for construction, reconstruction, alteration, improvement, replacement, or restoration begun before March 2, 1986, but only if the lesser of $1 million or 5% of the cost has been incurred or committed before that date.[29] However, for either transition provision to apply, the improvements must be placed in service before January 1, 1988.[30]

[26] Code §185(f).
[27] Act §242(c)(1).
[28] Act §242(c)(2)(A).
[29] Act §242(c)(2)(B).
[30] Act §242(c).

VII. Deduction for Bus and Freight Forwarder Operating Authority

Until enactment of the Bus Regulatory Reform Act of 1982,[31] intercity bus operators had to obtain operating permits from the Interstate Commerce Commission for particular routes. Only a limited number of permits were granted, giving protection against competition to some carriers. Thus, these authorities were considered a substantial part of a bus operator's assets and could be used as loan collateral.[32] Deregulation in 1982 increased the number of authorities granted and so authorities held previously became essentially worthless.[33]

Prior to the enactment of TRA 1986, no deduction was allowed for the decline in value of bus operating permits or licenses or freight forwarder operating authorities resulting from legislation which expanded the number of permits or licenses issued. The courts have denied the deduction on the ground that such permits and licenses continue to have value because the taxpayer is permitted to carry on the business.[34] However, under §266 of the Economic Recovery Tax Act of 1981,[35] motor carriers were granted a special 60-month deduction for the loss in value of operating authorities resulting from deregulation of the industry under the Motor Carrier Act of 1980.[36]

Section 243 of TRA 1986 amends §266 of the Economic Recovery Tax Act of 1981[37] to extend the 60-month ratable deduction allowed for motor carrier operating authorities to bus operating authorities. The deduction is based on the adjusted bases of the authorities. Eligible bus operating authorities include those issued under subchapter II of chapter 109 of title 49, United States Code and those issued for intrastate transportation of passengers by the appropriate State agency.[38] Further, only permits held on November 19, 1982 (the date of enactment of the Bus Regulatory Reform Act) or acquired under a binding contract in effect on that date are eligible for the 60-month deduction.[39]

The 60-month deduction is also extended to freight forwarder operating authorities.[40] However, for freight forwarders, the deduction is dependent on deregulation.[41] Also, the 60-month period begins with the later of the deregulation month or, at the election of the taxpayer, the first month of the taxpayer's first taxable year beginning after the deregulation month.[42] The "deregulation month" is defined as the month in which the Treasury Secretary determines that a federal law has been enacted which deregulates the freight forwarding industry.[43] For an au-

[31] P.L. 97-261.
[32] S. Rept. No. 313, 99th Cong., 2d Sess. 257.
[33] *Ibid.*
[34] *See, e.g. Consolidated Freight Lines, Inc. v. Comr.*, 37 B.T.A. 576 (1938), aff'd, 101 F.2d 813 (9th Cir.), cert. denied, 308 U.S. 562 (1939); *Beatty v. Comr.*, 46 T.C. 835 (1966).
[35] P.L. 97-34.
[36] P.L. 96-296.
[37] P.L. 97-34.
[38] Act §243(a)(3).
[39] Act §243(a)(2).
[40] Act §243(b)(1).
[41] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-80.
[42] Act §243(b)(2)(A).
[43] Act §243(b)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

thority to qualify, it must be held at the beginning of the 60-month period,[44] and the adjusted basis for authorities for purposes of the deduction may not exceed the adjusted basis as of the start of the applicable 60-month period.[45]

As stated above, only bus operating authorities held on November 19, 1982, or acquired after that date under a binding contract in effect on that date are eligible for the 60-month deduction.[46] Hence, the effective date for the bus operating authority deduction is retroactive to taxable years ending after November 18, 1982.[47] Accordingly, the Act extends the statute of limitations for filing refund and credit claims for overpayments resulting from the new deduction. If a refund or credit claim is barred on or before one year after the date of enactment of TRA 1986 (October 22, 1986), the refund or credit may be allowed if a claim is filed on or before the date which is 18 months after the date of enactment.[48]

For freight forwarders, the effective date is for taxable years ending after the month preceding the deregulation month.[49]

[44] Act §243(b)(2)(B).
[45] Act §243(b)(2)(C).
[46] Act §243(d)(1).
[47] Act §243(d)(1)(A).
[48] Act §243(d)(1)(B).
[49] Act §243(d)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 8

MISCELLANEOUS BUSINESS DEDUCTIONS

John F. Lefevere, Esq.
Lucia N. Smeal, Esq.
John Freeman Blake, Esq.
Charles E. Taylor, Esq.
Silverstein and Mullens
Washington, D.C.

I. Modification of Hobby Loss Deduction

A. Introduction

Under §183 of the Code, no deductions are permitted (except those specifically allowed by that section) with respect to an activity engaged in by an individual or S corporation if the activity is "not engaged in for profit." An activity not engaged in for profit is one for which deductions are not allowable as trade or business expenses,[1] expenses for the production or collection of income,[2] or expenses for the management, conservation, or maintenance of property held for the production of income.[3] Therefore, if a taxpayer shows that his activity constitutes a trade or business or is undertaken for the production of income, which, in turn, requires the taxpayer to demonstrate a profit motive in entering into the business or income-producing activity, the deduction limitation of §183 does not apply.

The courts generally apply a facts and circumstances test to determine whether a particular activity constitutes a not-for-profit activity. The Tax Court has applied a "predominant profit motive" test,[4] while the Claims Court has created a standard which calls for entering a transaction "with the objective of, and a reasonable chance of making, a reasonable profit apart from tax considerations." [5] However, §183(d) creates a statutory presumption of profit intent if the gross income from the taxpayer's activity exceeds the deductions attributable to that activity for at least two taxable years out of the five consecutive taxable years ending with the taxable year under consideration. The Commissioner can rebut this statutory presumption, however.[6] A special rule applies in the case of activities consisting in large part of the breeding, training, showing or racing of horses. In this case, there is a presumption of profit intent if gross income exceeds deductions for two or more of the seven consecutive taxable years ending in the taxable year in question.[7]

In some cases, taxpayers have arranged a profit through the sale of assets or have managed to show a slight profit, sometimes through accounting manipulations. The Tax Court has generally ignored these schemes,[8] but the nature of the §183(d) presumptions tends to encourage their use.

B. Overview

Under the Tax Reform Act of 1986 (the "Act"), the number of taxable years in which gross income must exceed deductions for purposes of the statutory presumption of profit intent is expanded from two years to three years. Act §143(a). In the case of the presumption relating to the breeding, training, racing, or showing of horses, however, the number of taxable years in which a profit must be shown remains two out of seven. Under a provision (Code §67) limiting the deductibility of miscellaneous itemized deductions, deductions for hobby expenses (other than those costs which are otherwise deductible without reference to whether they were incurred in an activity engaged in for profit will be disallowed except to the extent that they exceed 2% of adjusted gross income when aggregated with all other miscellaneous itemized deductions.

C. Detailed Analysis

1. Section 183(d) Presumption

The Tax Reform Act of 1986 [9] amends §183(d) to provide that if the gross income from an activity exceeds the deductions attributable to it (without regard to whether or not the activity is engaged in for profit) in three or more of the taxable years in a period of five consecutive taxable years, the activity is presumed to be engaged in for profit.[10] However, the presumption of a profit intent in the case of an activity consisting in major part of the breeding, training, showing, or racing of horses retains its existing testing period of two out of seven taxable years.[11] These changes

[1] §162(a).
[2] §212(1).
[3] §212(2).
[4] *See, e.g., Pickren v. Comr.*, 41 T.C.M. 834 (1981).
[5] *Johnson v. U.S.*, 86-2 USTC ¶9705 (Cl. Ct. 1986).
[6] §183(d) and Regs. §1.183-1(c)(1).
[7] §183(d) and Regs. §1.183-1(c)(3).
[8] *See, e.g., Est. of Power v. Comr.*, 46 T.C.M. 1333 (1983), aff'd, 84-2 USTC ¶9590 (1st Cir. 1984) and *Hager v. Comr.*, 76 T.C. 759 (1981).
[9] P.L. 99-514.
[10] Act §143(a)(1) amending Code §183(d).
[11] Act §143(a)(2) amending Code §183(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

are effective for taxable years beginning after December 31, 1986.[12] The Conference Report notes that, under the revised rule, an activity carried on by a taxpayer during 1987 is presumed not to be a hobby in that year if the activity is profitable in any three years out of the five calendar years 1983 through 1987.[13]

The legislative history does not indicate change in the general rule that an activity can still meet the for-profit standard even if the presumption is not met. Thus, the facts and circumstances test is retained and can be used by the Service to overcome the presumption.

The expansion of the number of years in the test period is the result of concern that the two-year period unduly benefited some taxpayers who structured their earnings and expenses in order to realize a profit in at least two out of five consecutive taxable years. It was felt that some taxpayers would incur losses as a cost of personal recreation if they could then take advantage of the presumption and be treated as engaging in a profit-seeking activity, given the subjective nature of the facts and circumstances test.[14]

2. Treatment under 2% Floor

The 1986 TRA also adds new Code §67 which allows miscellaneous itemized deductions to be taken only to the extent that they exceed 2% of adjusted gross income.[15] Code §67(b), which lists those itemized deductions that are excluded from the term "miscellaneous itemized deductions" for purposes of the 2% floor, does not include the deduction allowable under §183. Thus, effective for taxable years beginning after December 31, 1986,[16] the hobby loss deduction is subject to the 2% floor. Moreover, under new §56(b)(1)(A)(i) of the Code (as added by Act §701(a)), no deduction is permitted for any miscellaneous deduction as defined in §67(b) for purposes of determining the amount of an individual's alternative minimum taxable income. Thus, the hobby loss deduction will be completely disallowed in computing an individual's alternative minimum tax for taxable years beginning after 1986.

II. Home Office Deductions

A. Introduction

Despite the general rule that no deductions are permitted for personal or living expenses except as expressly allowed by the Code,[17] a taxpayer may take deductions for interest,[18] certain taxes,[19] and casualty losses [20] attributable to his personal residence. Prior to 1976, a deduction was allowed for an allocable portion of the expenses incurred in maintaining a personal residence if the taxpayer used a portion of that residence either in his trade or business or in the production of income. The regulations provide, however, that if the taxpayer only incidentally conducted the business in his home, the related expenses were treated as nondeductible personal expenses.[21]

The maintenance of an office in a personal residence typically occurs in two situations: self-employed taxpayers, and employees maintaining offices in connection with their duties as employees. In the absence of statutory guidance prior to 1976, a conflict arose between the Service, which ruled that the office must be required by the employer as a condition of employment and regularly used for the performance of the employee's duties,[22] and the courts, which allowed the deduction if the office were found to be "appropriate and helpful" to the employee's business.[23] The Tax Court described this latter test as "whether, like any other business expense, the maintenance of an office in the home is appropriate and helpful under all the circumstances." [24]

In order to resolve the conflict between the Service and the courts, Congress, in the Tax Reform Act of 1976, created definitive rules for the deductibility of home office expenses by adding Code §280A.[25]

Section 280A(a) disallows all deductions for a dwelling unit used by the taxpayer as his residence during the taxable year, except for those deductions otherwise allowed under §280A and those which are otherwise allowable in connection with the taxpayer's trade or business or with his income-producing activity.[26] However, the statute sets forth specific exceptions for certain business uses, rental use, storage use, and use for day care services; expenses for these activities are deductible as limited by the statute.[27] All of these exceptions require that the residence to be used on a "regular basis" for the qualifying activity.

1. Rental Use

The exception contained in §280A(c)(3) provides that §280A(a) "shall not apply to any item which is attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e))." The parenthetical reference to §280A(e) is to the limitation on rental deductions to an amount proportionate to the ratio of number of days rented to total number of days used.

In *Feldman v. Comr.*,[28] the taxpayer, a managing partner and director in an accounting firm, custom built a nine-room house with a two-car garage four miles from his employer's office. The following year, the taxpayer leased a 210 square foot area (which had been designed for office use) and one of the two garage spaces, where he kept his

---

[12] Act §151(a). The Conference Report on H.R. 3838, "Tax Reform Act of 1986," H. Rep. 99-841, Vol. II (Sept. 18, 1986) (hereinafter "Conf. Rep.") states that the effective date is for taxable years beginning on or after January 1, 1987, a minor variation from the text of the bill. Conf. Rep. at II-36.

[13] Conf. Rep. at II-36.

[14] H.R. Rep. No. 426, 99th Cong., 1st Sess. 131 (December 7, 1985). *See also* S. Rep. No. 313, 99th Cong., 2d Sess. 80 (May 29, 1986).

[15] Act §132 adding Code §67.

[16] Act §151(a).

[17] Code §262.

[18] Code §163.

[19] Code §164.

[20] Code §165.

[21] Regs. §1.262-1(b)(3).

[22] *See* Rev. Rul. 62-180, 1962-2 C.B. 52.

[23] *See e.g. Newi v. Comr.*, T.C. Memo 1969-131, aff'd 432 F.2d 998 (2d Cir. 1970). The standard was also applied to an investor maintaining a home office in *Anderson v. Comr.*, T.C. Memo 1974-49.

[24] *Bodzin v. Comr.*, 60 T.C. 820, 825 (1973), rev'd, 509 F.2d 679 (4th Cir. 1975), cert. denied, 423 U.S. 825 (1975).

[25] P.L. 94-455, §601(a). *See* S. Rep. No. 938, 94th Cong., 2d Sess. 147 (1976).

[26] §280A(a) and (b).

[27] §280A(c)(1)-(5).

[28] 84 T.C. 1 (1985).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

business automobile, to his employer. In taxable year 1979, he reported $5,400 as rental income and deducted $2,975 in depreciation and other costs. He met frequently in the home office with other firm directors because of the continual interruptions he experienced at his employer's office. On rare occasions he met there with clients. Over three dissents, the court held that the deductions were allowable under §280A(c)(3), since the payments were *bona fide* rental payments to the extent they were reasonable.

The Ninth Circuit affirmed *Feldman,*[29] holding that the taxpayer's interpretation that the four exceptions to §280A were independent of one another drew "support from the plain meaning of the statute." The Service had argued on appeal that amendments in the pending tax reform bill (H.R. 3838) would disallow a deduction for rental of a taxpayer's dwelling unit by his employer. However, the Ninth Circuit refused to view the possible action by Congress as indicating anything other than a possible "tacit admission that the statute as enacted contains an undesirable loophole." [30]

2. Amount of Deductions

The deductions allowed under the exceptions to §280A are limited by §280A(c)(5) to the excess of: (1) gross income derived from the use of the dwelling unit, over (2) the deductions allocable to the unit which are allowable without regard to business use. The effect of this limitation is to prevent a taxpayer from deducting a loss attributable to home office expenses. Under a tier system contained in the regulations, expenses allocable to home office use are deducted in the following order: (1) expenses, such as real estate taxes and mortgage interest, that are deductible without regard to business use; (2) expenses attributable to business use, other than expenses that result in an adjustment to basis; and (3) expenses, such as depreciation, that result in an adjustment to basis.[31]

The Service, in proposed regulations, has interpreted the gross income limitation of §280A(c)(5) restrictively by defining "gross income derived from use of a dwelling unit" as gross income from the business activity in the unit reduced by expenditures required for the activity but not allocable to the use of the unit itself, such as expenditures for supplies and compensation paid to other persons.[32] The Tax Court rejected the Service's position in *Scott v. Comr.*[33]

The taxpayer in *Scott* ran two businesses, a chemical analysis business and a rental business, out of an office in a separate building located adjacent to his home. The taxpayer claimed $1,965 in home office expenses (such as insurance, utilities, taxes, and repairs) which were allocable to the building. Under the Service's position, however, the home office expenses could not be used at all because expenses from both businesses not allocable to the office building ($31,985) exceeded gross income from the two businesses ($23,518).

The Tax Court rejected this approach and, noting that the court would hold a final regulation to that effect invalid, held that the proposed regulation (which is not entitled to judicial deference) was inconsistent with the statute, the legislative history, and a similar limitation in §183.

The Service in *Scott* also contended that the taxpayer had no gross income from the use of the home office because other business expenses exceeded business income. The court ruled that the phrase, "gross income derived from such use" was intended to distinguish income derived from other business activities (which is to be disregarded). The court held that the taxpayer was entitled to deduct the home office expenses since they did not exceed the gross income derived from the home office businesses, reduced by the deductions allowable without regard to such business use.

B. Overview

Reacting to the Tax Court's decision in *Feldman,* Congress moved to apply the existing limitations on the deductibility of home office expenses when an employee leases a portion of a home to his or her employer. Moreover, in response to the *Scott* decision, the home office deduction is limited to the taxpayer's net income from his business, but disallowed deductions may be carried forward to later years. However, the carryforward will also be subject to the net income limitation in those subsequent years.

C. Detailed Analysis

1. Requirements for Home Office Deductions

The amendment to §280A creates an absolute prohibition (with the exception of home mortgage interest and real property deductions, which would be deductible in any event) against deducting expenses attributable to the use of a home as a home office if an employee rents a portion of his or her home to the employer. This is accomplished by providing that §280A(c)(1) and (3), which provide a business use exception to the general rule prohibiting home office deductions, will not apply if the taxpayer rents all or a portion of his dwelling unit to his employer during a period in which he uses such dwelling unit in performing services as an employee.[34] The prohibition also applies to an individual who is an independent contractor since the House Report states that the individual will be treated as an employee for that purpose (and the party for whom the services are performed will be treated as the employer).[35]

Noting that generally allowing deductions for home office use under the limitations contained in §280A inherently creates the potential for abuse, the legislative history indicates a particular twin concern with the employer-employee lease relationship. First, there is the question of whether an employer-employee lease agreement can ever be negotiated at arms-length, especially when the employer can, as in the *Feldman* situation, provide additional tax deductions to the employee at no extra cost to itself.

[29] 791 F. 2d 781 (9th Cir. 1986).

[30] *Id.* at 784. The Ninth Circuit also noted that the House amendment "proves only that its members dislike the policy implications of the Tax Court's decision, not that the decision misconstrued the statute." *Id.*

[31] Prop. Regs. §1.280A-2(i)(5) (Aug. 7, 1980).

[32] Prop. Regs. §1.280A-2(i)(2)(iii) (July 21, 1983).

[33] 84 T.C. 683 (1985).

[34] Act §143(b), adding Code §280A(c)(6).

[35] H.R. Rep. (hereinafter "H. Rep.") No. 426, 99th Cong., 1st Sess. 134 (1985).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Second, leasing arrangements such as those involved in *Feldman* could be used to create a sham transaction in which a portion of the taxpayer employee's salary is paid in the form of rent.[36] In fact, the Tax Court in *Feldman* allowed a home office deduction despite its own findings that the rental was not agreed to at arm's length and was actually made for more than the fair rental value of the space which was purportedly rented.[37]

This rule is effective for taxable years beginning after December 31, 1986.[38]

2. Limitations on Amount of Deduction

a. In General

Congress also sought to overturn the decision in *Scott v. Comr.*, which permits taxpayers to use home office deductions to offset unrelated income by either creating or increasing a loss from the business activity carried on in the home office. Under the Act, the amount of home office deductions which may be taken is limited to the taxpayer's net income from the business, except in the case of expenses (such as home mortgage interest) which are otherwise deductible.[39] This means that the taxpayer's gross income from the activity conducted in his home office is reduced by all other deductible expenses attributable to the activity (but not allocable to the dwelling unit itself) to arrive at the net income figure from which to deduct qualifying home office expenses. Thus, the home office deduction amounts could not be utilized by the taxpayer to either create or increase a net loss from the business activity to which they relate.[40] The effect of the law is to statutorily adopt Prop. Regs. §1.280A-2(i)(2)(iii).

b. Carryover of Unused Home Office Deductions

Those home office deductions which are disallowed due to the limitation on deductions against net income (described above) can be carried forward to subsequent taxable years. However, such a carryforward deduction continues to be subject to the income limitation in all subsequent years to prevent the creation or increase of a net loss (as described at II, c, 2, a).[41] The ability to carry forward unused deductions should mitigate some of the harshness of disallowing a deduction to the extent it exceeds net income from the taxpayer's business.

The provisions for limitation on the home office deduction as well as the carryforward rule are effective for taxable years beginning after 1986.

III. Five-Year Amortization of Trademark and Trade Name Expenditures Repealed

Prior to the Tax Reform Act of 1986, Code §177 permitted taxpayers to amortize over not less than 60 months the costs of acquiring, protecting, expanding, registering, or defending a trademark or tradename. However, amortization was not allowed for consideration paid for existing trademarks or trade names.[42]

The election to amortize trademark and trade name expenditures over five years permitted under Code §177 is repealed by §241 of the 1986 Act. After repeal, these expenditures will have to be capitalized and recovered upon disposition of the asset. Conference Report, p. II-78.

Repeal is effective generally for costs paid or incurred after December 31, 1986.[43] A limited transition rule is provided, however, in two situations. First, costs paid or incurred under a binding contract entered into before March 2, 1986 will be amortizable as under prior law.[44] Further, costs incurred in the development, protection, expansion, registration, or defense of a trademark or trade name begun before March 2, 1986 will also be amortizable under prior law, but only if the lesser of $1 million or 5% of the aggregate cost has been incurred or committed before that date.[45] However, these transition rules apply only to trademark and trade names that are placed in service before January 1, 1988.[46]

IV. Expensing of Certain Architectural Barriers Expenditures Made Permanent

Code §190 permits taxpayers to elect to deduct currently up to $35,000 of capital expenditures for the removal of architectural and transportation barriers from facilities or vehicles used in the taxpayer's trade or business. To qualify, removal must make the facilities or vehicles more accessible to the handicapped and elderly, and must meet the standard for barrier-free design promulgated by the Secretary with the concurrence of the Architectural and Transportation Barriers Compliance Board.[47]

Section 244 of the Act makes permanent the expensing election for architectural and transportation barrier removal, which was scheduled to expire after December 31, 1985 under prior law. Thus, taxpayers may still deduct these expenses in the year paid or incurred rather than capitalizing them.

The permanent deduction is available for expenses incurred in taxable years beginning after December 31, 1983.[48]

V. Deduction for Employee Achievement Awards Clarified [Act §122(d)]

Act §§122(c) and (d) reorganize Code §274 by removing from Code §274(b) references to employee achievement awards, which in turn are dealt with in Code §274(j) (as added by the Act). This change to the Code does not change the substance of the deduction previously allowed under Code §274(b), and appears to have been made for the purpose of clarifying the cross referencing from other

[36] *Id.* at 133-34.
[37] *Id. See also* 84 T.C. at 5-7.
[38] Act §151(a).
[39] Act §143(c), amending Code §280A(c)(5)(B).
[40] H.R. Rep. at 134-35; S. Rep. No. 313, 99th Cong., 2d Sess. 83-84 (1986).
[41] Conf. Rep. No. 841, 99th Cong., 2d Sess. II-35 (1986).
[42] Code §177(b)(3).
[43] Act §241(c)(1).
[44] Act §241(c)(2)(A).
[45] Act §241(c)(2)(B).
[46] Act §241(c) (flush language).
[47] Code §190(b)(1)-(2).
[48] Code §190(d)(2), as amended by Act §244.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

sections (notably §74(c)). Under the Act, as under prior law, an employee achievement award is a prize excludible from the employee's gross income (under §74(c), as added by the Act), and deductible by the employer (under §274(j)) to the extent that the cost to the employer does not exceed the amount allowable as a deduction under §274(j)(2). If the cost to the employer exceeds the deduction allowed under §274(j), the excess amount is included in the recipient's gross income.

Under §274(j)(3), an employee achievement award is an award given to an employee in recognition of the employee's length of service, productivity, or safety achievement, and the cost of which does not exceed $400, or if made under a qualified award plan does not exceed $1,600. A qualified plan award is an employee achievement award awarded as part of a written plan that does not discriminate in favor of highly compensated employees (as defined in Code §414(q)) and which provides awards the average cost of which do not exceed $400.

Act §122(e) provides that if an employee award is excludable from wages for income tax purposes, it is also excludable for employment tax purposes and from the social security benefit base.

This provision is effective for prizes and awards granted after December 31, 1986.[49]

VI. Bad Debt Reserve (Other Than Financial Institutions)

A. Background

Section 166 of the Internal Revenue Code provides a statutory deduction for both business and nonbusiness bad debts. A taxpayer faced with business bad debts may select one of two methods for deducting them: (1) the specific charge-off method, or (2) the reserve method for bad debts.[50] This selection is made through a taxpayer election made at the time of the filing of the tax return for the taxpayer's first fiscal year in which faced with a bad debt situation.[51] The specific charge-off method permits a deduction for a bad debt when such debt becomes either partially or wholly worthless; however, if the debt is later recovered, that amount is then included in income. Regs. §1.166-3. Under the specific charge-off method, a debt's total worthlessness is established through facts and circumstances, and depends in large part upon both the financial condition of the debtor and the value of any underlying collateral.[52] A wholly worthless debt becomes fully deductible in the year in which its worthlessness is established. Regs. §1.166-3(b). For a complete discussion of the rules relating to §166, *See* 19 T.M., *Bad Debts*.

1. In General

Under §166(c), the reserve method permits a deduction for a reasonable addition to a reserve for bad debts. The theory of the reserve is that taxpayers should be able to make an overall estimate of the uncollectible portion of its receivables as well as notes, loans and certain other evidences of indebtedness, and offset them against the applicable asset account. Thus, the Code permits an adjustment to the reserve in order to adjust the beginning reserve balance during the year for bad debt losses and recoveries made on previously deducted debts. This adjustment is necessary to properly reflect the receivables balance at the end of the taxable year. The reserve method offers an advantage to the taxpayer in that it does not have to establish either partial or complete worthlessness in order to satisfy the requirements of the specific charge-off method. It does, however, create the additional burden of proving that the addition to the reserve is "reasonable."

2. Computing the Addition to Reserve

Since the reserve for bad debt method necessarily involves estimating the addition to the taxpayer's reserve (as opposed to the precise measurement required under specific charge-off method), many formulas have emerged for estimating the reserve. The most prominent judicial formula is contained in *Black Motor Co. v. Comr.*[53] The *Black Motor* bad debt formula creates an experience factor by first dividing the average outstanding accounts receivable balance for six years (*i.e.*, the balance at the end of the current year plus that of the preceding five years) into the average debts actually charged off (after netting for recovered amounts) during the same period. The "experience factor" is then applied to the total outstanding receivables balance for the end of the current year less the reserve balance at year-end after charge-offs and recoveries. The result, if reasonable, is the addition to reserves for the year. Thus, the *Black Motor* formula compares the charge off of debts for the past six years with the amount of receivables during that period and applies the resulting percentage to the outstanding receivables at the end of the taxable year under consideration.

3. Bad Debt Reserves for Guarantees of Dealers

If a seller of goods receives a debt obligation from a purchaser in exchange for either property or services and then sells the debt obligation to a third party financing entity (*i.e.*, factors its receivables) with recourse, the seller may be called upon to guarantee the payment of the purchaser to the financing entity. The taxpayer's duty may arise as a guarantor, endorser, or indemnitor of the debt obligation. Absent a statutory provision, such a guarantee would not give rise to a deduction for a reserve for bad debt because technically the purchaser does not directly owe a debt to the taxpayer at that point. However, Code §166(f) permits a deduction for additions to a special reserve for bad debt for dealers in real or tangible personal property.

The §166(f) reserve applies to such dealers[54] for bad debts arising out of their liability as a guarantor, endorser,

[49] Cf. Act §151(c).
[50] Regs. §1.166-1(a).
[51] Regs. §1.166-1(b).
[52] Regs. §1.166-2(a).

[53] 41 B.T.A. 300 (1940), aff'd on other issues, 125 F. 2d 977 (6th Cir. 1942), acq. 1940-1 C.B. 1.
[54] Dealers are defined in Regs. §1.166-10(a)(1) as "a person who regularly sells property in the ordinary course of the person's trade or business."

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

or indemnitor of debt obligations attributable to the sale of real or tangible personal property (but not securities)[55] in the ordinary course of business. This reserve must be maintained separately from the reserve available under §166(c)[56] and is the exclusive reserve for guarantors, endorsers or indemnitors of debt obligations.[57]

B. Overview

The Tax Reform Act of 1986 repeals the reserve method for bad debts for taxpayers other than specified financial institutions. These taxpayers will be required to use the specific charge-off method in accounting for losses on bad debts. A wholly worthless business debt remains deductible in full in the year that it becomes worthless, thus retaining existing law on this point. The reserve method is repealed for dealers who guarantee, endorse, or provide indemnity agreements for debt obligations arising out of the sale by that dealer of real or tangible personal property in the ordinary course of business.

Any change from the reserve method of accounting for bad debts will be treated as a taxpayer-initiated change in method of accounting with the consent of the Secretary of the Treasury. To prevent taxpayers from deducting losses on debts twice, the new law generally requires that any balance in any reserve for bad debts as of the effective date be included in income ratably over a 4-year period. No offset to the full amount in the reserve account is allowed for any anticipated amounts that will not be currently accrued as income (under the rules allowing accrual basis service providers to exclude from income amounts which are statistically determined not to be collectible) until such amounts are actually collected.

Act §801 also creates new §448. Subsection 448(d)(5) provides that any accrual method taxpayer who receives amounts for the performance of services shall not be required to accrue any portion of those amounts which, based upon his experience, will not be collected. This provision, which amounts to a newly created reserve for bad debt is discussed fully in Chapter 22, Part II., *infra.*

C. Detailed Analysis

1. Bad Debt Reserve Repealed

The availability of the reserve method for bad debts for all taxpayers other than "small banks" (commercial banks whose assets do not exceed $500 million) and thrift institutions is repealed,[58] effective for taxable years beginning after December 31, 1986.[59] As a result, those taxpayers covered by the statute will be required to use the specific charge-off method in accounting for losses on bad debts. This is an effort to resolve the inconsistency between the bad debt reserve and the treatment of all other deductions under the "all events" test, since the use of the reserve method results in the current deduction of what are statistically future losses.[60] Further, the reserve method permits the allowance of a deduction before the taxable year in which it occurs, and therefore, the value of the deduction to the taxpayer is overstated while his overall tax liability is understated.[61]

The exception for "small banks" and thrift institutions was included because of Congress' concern that the repeal of the reserve method would jeopardize the ability of those institutions to maintain government-imposed capital requirements for lending and other activities.[62] However, a Senate move [63] to preserve the reserve method for finance companies (on the grounds of competitive disadvantage) failed to be included in the final agreement.

The Conference Report notes that (following repeal of the reserve method) in determining whether a debt is worthless when held by a utility, the fact that the utility is required to continue to provide services to a customer whose account has otherwise been determined to be uncollectible will not be considered as evidence that the debt is not worthless for federal income tax purposes.[64]

The reserve for bad debt method is also repealed for dealers who guarantee, endorse, or provide indemnity agreements with respect to debt obligations arising out of the sale of real or tangible personal property in the ordinary course of business by that dealer.[65] This provision also applies to taxable years beginning after December 31, 1986.[66] Thus, expenses which arise from a dealer's guarantee, endorsement or indemnity agreement are not deductible until the dealer suffers a loss as a result of honoring his guarantee, endorsement, or agreement. However, where the dealer is subrogated to the rights of the original creditor, the loss becomes deductible at the time the subrogation rights become worthless (either wholly or partially) and the amount is charged off on the dealer's books.[67]

The final agreement did not include a "booking requirement" contained in both House and Senate bills which would have limited the deduction of wholly worthless business debts to the amount written off on the taxpayer's books in an effort to conform the treatment of wholly worthless debts to partially worthless debts.[68] Under this rule no debt would be deductible as wholly or partially worthless for tax purposes until it was charged off on the taxpayer's books. Thus, as under pre-1986 TRA law, a wholly worthless debt will be deductible in full in the year that it becomes worthless. Conference Report at II-315.

2. Transitional Rules

Under the 1986 Act, any change from the reserve method to the specific charge-off method is treated as a change in the taxpayer's method of accounting which is

[55] *See* Regs. §1.166-10(a)(3). This regulation does, however, extend coverage of the reserve to other property related to the property with respect to which the taxpayer is a dealer.
[56] §166(f)(4)(A).
[57] §166(f)(2).
[58] Act §805(a) repealing §166(c).
[59] Act §805(d)(1).
[60] *See* H. Rept. No. 426, 99th Cong., 1st Sess. 640 (1985).
[61] *Id.*
[62] S. Rept. No. 313, 99th Cong., 2d Sess. 155 (1986).
[63] *Id.*
[64] Conf. Rept. at II-315.
[65] Act §805(b) repealing §166(f) and redesignating §166(g) as §166(f).
[66] Act §805(d)(1).
[67] S. Rept. at 157.
[68] *See* H. Rept. at 640-641 and S. Rept. at 156-157. *See* Conf. Rep. at II-315.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

both initiated by the taxpayer and consented to by the Secretary of the Treasury.[69] The full amount of any balance existing in any reserve for bad debts as of the effective date will be restored to income ratably in each of the first four taxable years beginning after December 31, 1986.[70] No offset will be permitted for any anticipated amounts which will not be currently accrued as income under the rules that allow accrual basis service providers to exclude from income (until actually collected) those amounts that are statistically determined not to be collectible.[71] The amount of reserve subject to inclusion, where the reserve is established for a dealer's guarantees, endorsements or indemnity agreements, is subject to reduction by the amount of the remaining balance in any suspense account established under §166(f)(4).[72]

The Conference Report notes that the conferees intend to allow net operating loss and tax credit carryforwards to offset any positive §481 adjustment. Moreover, it was also the conferees' intent to recognize the §481 adjustment on taxable income ratably throughout the year in question for purposes of determining estimated tax payments.[73]

3. Technical Amendments

As a result of the repeal of both §166(c) and §166(f), certain technical amendments are made to Code §81,[74] §108,[75] §461(h),[76] and §805.[77]

4. Treasury Report Required

In an action taken by neither the House nor Senate, the conferees direct the Secretary of the Treasury to study and issue a report concerning the appropriate criteria to be used in determining if a debt is worthless for federal income tax purposes. The focus of this report will be the circumstances under which a rule providing for a conclusive or rebuttable presumption of the worthlessness of an indebtedness is appropriate. The final report must be submitted to the House Ways and Means Committee and the Senate Finance Committee by January 1, 1988.[78]

5. Planning Suggestions

That portion of the new law which requires that the existing reserve balance be restored into income ratably over a 4-year period should cause taxpayers to carefully review proposed reserve additions for the last year under the current reserve method. The existing reserve is included in income regardless of how long the reserve method has been in use by the taxpayer. Taxpayers should have the maximum reasonable amount placed in reserve for the last taxable year, since that would provide a current income tax deduction and position recapture to occur over the following four taxable years when the tax rates generally have decreased.

VII. Qualified Discount Coupons

A. Background

Retail discount coupons induce the purchase of a product through the allowance of a discount on the purchase price of the item. Discounts are typically available either in terms of a percentage of price or as a specified amount of cash off the retail price.

Section 466(a) of the Code provides that issuers of "qualified discount coupons" who use the accrual method of accounting may elect to deduct the cost of the coupons which are outstanding at the close of a taxable year and received by the taxpayer for redemption within a 6-month period immediately following the close of the taxable year.[79] The taxpayer's election constitutes a method of accounting and must be made for each trade or business of the taxpayer.[80] The taxpayer may be required to establish a suspense account to prevent the bunching of deductions in the year of election.[81]

A "qualified discount coupon" is a coupon which is both issued and redeemable by a taxpayer, and allows a discount on the purchase price of either merchandise or other tangible personal property.[82] However, the coupon cannot be used (either by itself or in conjunction with any other type of coupon) to reduce the price of any item by more than $5.00.[83]

Under §466(b)(4) [84] of the Code, the election is available only if a redemption chain is set up so that someone other than the issuer redeems the coupon from the consumer who receives the discount. Thus, for example, a supermarket must be interposed to redeem a "10% off" coupon for cereal on behalf of the cereal manufacturer which issued the coupon. The special rule for qualified discount coupons is an exception to the general rules of accounting and specifically to the economic performance test as measured by the "all events" test.[85] As a result, the operation of the rules on qualified discount coupons sometimes permits a deduction to be allowed in a year prior to the year in which the income is recognized. This occurs because a coupon received during the redemption period is deductible in computing the prior year's income even though it may relate to the sale of a product where the sales transaction took place in the current taxable year. Moreover, this

[69] Act §805(d)(2)(A) and (B).
[70] Act §805(d)(2)(C)(i) and (ii).
[71] Conf. Rept. at II-315-16.
[72] *Id.* at II-316.
[73] *Id.*
[74] Act §805(c)(1)(A) amending Code §81 to delete existing §81(1).
[75] Act §805(c)(2), (3), and (4) amending Code §108(e)(7)(A)(ii) by striking out the cross-reference to §166(c), striking out §108(e)(7)(B) and redesignating the remaining subparagraphs, and changing the cross-reference to subparagraphs in the redesignated §108(e)(7)(E), respectively.
[76] Act §805(c)(5) strikes out existing Code §461(h)(5)(A) and redesignates the remaining subparagraphs.
[77] Act §805(c)(6) strikes out the cross-reference to Code §166(c) contained in Code §805(b)(2), and redesignates the remaining paragraphs.
[78] Conf. Rept. at II-316.
[79] Code §466(c)(2)(A) provides for the 6 month period. However, under Code §466(c)(2)(B), the taxpayer may elect a shorter period than the statutory 6 month redemption period.
[80] Revocation of this election is only available with the permission of the Secretary. *See* Regs. §1.466-3(a).
[81] Code §466(c). *See* Regs. §1.466-1(e)(3).
[82] Code §466(b)(1).
[83] Code §466(b)(3).
[84] *See* Regs. §1.466-1(c)(2)(ii).
[85] *See* §461(h)(5)(C) which specifically exempts §466 from the operation of §461(h).

inconsistency may occur even though the coupon was outstanding at the end of the prior taxable year.

B. Detailed Analysis

The 1986 TRA repeals §466,[86] effective for taxable years beginning after December 31, 1986.[87] Congress felt that the qualified discount coupon provision created an unwarranted exception to the general rules of tax accounting by allowing such costs to be considered outside the all events test. Moreover, it was felt that the mismatch of income and deduction described above results in an incorrect measurement of taxable income.[88]

After the repeal becomes effective, a deduction will be allowed only for the costs of redeeming qualified discount coupons in the taxable year in which received for redemption. This conforms the treatment of discount coupons to the treatment of other items under the economic performance test.[89]

A statutory provision is made for those taxpayers who have elected to apply §466 for the last taxable year beginning before January 1, 1987 and are being forced to change their method of accounting due to the repeal.[90] Act §823(c)(2) provides that this measure treats the change created by the repeal as initiated by the taxpayer and made with the consent of the Secretary. The Act further requires that the net adjustments which are required by §481 of the Internal Revenue Code of 1986 to be taken account by the taxpayer [91] shall be reduced by the balance (if any) in the suspense account, and the net amount taken into account over a period not longer than four years.[92] The Conference Report states the conferees' expectation that the concepts of Rev. Proc. 84-74 [93] will generally apply in determining the actual timing of recognition or expense resulting from this adjustment.[94] This revenue procedure is the principal Service pronouncement relating to procedures under Code §446 and Regs. §1.446-1(e) for obtaining the Commissioner's consent to a change in method of accounting.

The Conference Report, p. II-322, also notes the conferees' intention to allow the net operating loss and tax credit carryforwards to offset any positive §481 adjustment. Moreover, the Report also expresses the intention that, in determining estimated tax payments, the §481 adjustment will be recognized in taxable income ratably throughout the year in question.[95]

Certain conforming amendments are also made.[96]

VIII. Exceptions to Membership Organization Deduction Rules Expanded

A. Introduction

Under §277 of the Code, social clubs and certain other taxable membership organizations may generally deduct expenses related to the furnishing of goods or services to members only to the extent of that income which is derived from members or from transactions with members.[97] Moreover, the dividends-received deduction available under Code §§243-245 are not available to organizations falling within the general rule of Code §277(a).

The purpose of Code §277 is to prevent membership organizations which are not tax-exempt from escaping the tax on business or investment income by using such income to serve its membership at less than cost and then deducting the book loss resulting from deductions taken for the cost of providing services and other items of value to the membership.[98]

For purposes of this rule, a statutory exception is provided for certain financial institutions,[99] insurance companies,[100] securities or commodities exchanges,[101] and certain membership organizations which made a §456(c) election prior to October 9, 1969.[102]

B. Detailed Analysis

The 1986 Act amends Code §277(b) by adding subsection (4) which provides that §277(a) shall not apply to an organization which is engaged primarily in the gathering and distribution of news to its members for publication.[103] This rule was reportedly a special exception created solely for Associated Press (a taxable membership organization) by Sen. Daniel Moynihan (D.- NY).[104] The amendment is effective for taxable years beginning after October 22, 1986, the date of enactment of the 1986 Act.[105]

IX. Certain Miscellaneous Business Costs Inventoried or Capitalized

A. Costs other than Interest

Under Code §263A, as added by Act §803(a), various costs which were previously deducted currently are now to be inventoried and deducted when property is sold or capitalized and recovered through depreciation. The Treasury Department is directed to prescribe regulations that

[86] Act §823(a).
[87] Act §823(c)(1).
[88] S. Rep. No. 313, 99th Cong. 2d Sess. 158 (1986).
[89] *See* S. Rep. at 159.
[90] Act §823(c)(2).
[91] The net adjustments are those which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. Code §481(a)(2).
[92] Act §823(c)(2). The Senate amendment provided for the net amount to be taken into account ratably over a period not exceeding five years, but the Conference bill language lowered this to four years. S. Rep. No. 313, 99th Cong., 2d Sess. 158 (1986) and H.R. Rep. No. 841, 99th Cong., 2d Sess., II-320-322 (1986).
[93] 1984-2 C.B. 736, clarifying, modifying and superseding Rev. Proc. 80-51, 1980-2 C.B. 818.
[94] Conf. Rep. No. 841, 99th Cong., 2d Sess. II-322 (1986).
[95] *Id.*
[96] Act §823(b)(1) which deletes the cross reference to §466 in Code §461(h)(5)(C) (dealing with those sections to which the economic performance test will not apply) and §823(b)(2) making a table of contents correction.
[97] Code §277(a).
[98] *See* Summary of Senate Amendments to H.R. 13270, Tax Reform Act of 1969, Part 1, 91st Cong., 1st Sess. 32-33 (1969).
[99] Code §277(b)(1).
[100] *Id.*
[101] Code §277(b)(3).
[102] Code §277(b)(2).
[103] Act §1604(a), amending Code §277(b).
[104] *See* Sheppard, "Last-Minute Amendments Stall Passage of Final Bill," Tax Notes 1150 (June 23, 1986).
[105] Act §1604(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

will govern the inclusion in inventory or capital accounts of all costs, both direct and indirect, (including taxes) which are (1) involved in the manufacture, construction, and other types of activity and are allocable to the production of real or tangible personal property and, (2) for certain large taxpayers, involved in the acquiring or holding for resale of inventory or other property acquired or held in the ordinary course of a trade or business.[106] These rules will not apply to *inter alia,* any property produced by the taxpayer pursuant to a long-term contract. §263A(c)(4). The rules do not modify existing treatment of the valuation of inventories on a basis other than cost (*e.g.* lower of cost or market valuations for first-in, first-out (FIFO) inventories) and do not apply to certain farmers. Conference Report at 305; §263A(d). It is expected that these rules will decrease the amount of expenses which are currently deductible and increase the amount of costs which are recovered through cost of sales, depreciation or amortization. A more complete discussion of this provision and its effective date is in Chapter 19, *infra.*

B. Interest Capitalization

Interest on debt is not treated as a cost allocable to inventory or items produced by a taxpayer. However, interest paid or incurred during the production period must be capitalized (1) for indebtedness directly attributable to production expenditures with respect to real, or tangible personal property produced by a taxpayer or (2) for indebtedness that could have been reduced if production expenditures had not been incurred.[107] Also, interest on indebtedness incurred or continued in connection with property used to produce property to which §263A(f) applies will be subject to this limitation. The production expenditures which are covered by this section are those for property which (1) has an estimated production period exceeding two years, (2) has an estimated production period exceeding one year if its cost exceeds $1,000,000, or (3) is real property, or property with a class life of 20 years or more (as determined under §168). §463A(f)(1) and (4). This amendment should decrease the amount of interest for which a current income tax deduction is allowed. A more complete discussion of this provision and its effective date is in Chapter 19, *infra.*

C. Sales and Transfer Tax Capitalization

As part of the repeal of the current deduction for state and local sales taxes, the 1986 TRA provides that any tax (other than certain property and income taxes) which is paid or accrued by the taxpayer in connection with the acquisition or disposition of property (*e.g.* sales taxes, real property transfer taxes) shall be treated as part of the acquisition cost or a reduction in the proceeds received upon the property's disposition.[108] A more complete discussion of this provision and its effective date is in Chapter 19, *infra.*

[106] Act §803, adding Code §263A.
[107] Act §803; §263A(f)(2).
[108] Act §134(a); §164(f)(4).

X. Technical Amendments To Passenger Automobile Listed Property Rules And Gas Guzzler Tax

A. Introduction

1. Definition of Passenger Automobile

The Tax Reform Act of 1984 [109] placed limits on the use of both the investment tax credit (ITC) and accelerated depreciation recovery system (ACRS) deductions taken on passenger automobiles used in the taxpayer's trade or business. Under §280F, as added by the 1984 Act, the ITC was limited to $1,000 and the ACRS deductions to $4,000 in the first year and $6,000 in each subsequent year until the full cost of the automobile is recovered.[110] In return for the repeal of the contemporaneous recordkeeping requirements imposed on business drivers by the 1984 Act, the drafters of the Contemporaneous Recordkeeping Repeal Act of 1985 (P.L. 99-44) succeeded in reducing the limitation on ITC and ACRS deductions to $675 for ITC and $3,200 for ACRS in the first year, with $4,800 in each subsequent year until recovery is complete.[111] These limitations apply only to "passenger automobiles" as that term is defined in pre-TRA 1986 §280F(d)(5). For purposes of these limitations, the 1984 Act defined a "passenger automobile" as any four-wheeled vehicle which is manufactured primarily for use on public streets, roads, and highways with a gross vehicle weight rating of 6,000 pounds or less. However, the definition excludes vehicles used directly in the business of transporting persons or property for compensation or hire.[112]

2. Listed Property

The business use of certain tangible personal property listed in Code §280F(d)(4) (and referred to as "listed property") for less than 50% of the total use of such property causes denial of ITC and extension of the period for cost recovery.[113] Listed property includes passenger automobiles and any other property used as a means of transportation, property used for recreation, entertainment, or amusement, computers and peripheral equipment (except for equipment used exclusively at a regular business establishment or qualified home office), and other property specified in regulations.

3. Gas Guzzler Tax

The Energy Tax Act of 1978 [114] imposed a "gas guzzler" tax on automobile manufacturers whose automobiles (model years 1980 and later) had a fuel economy level below those levels published in the statute.[115] The term "automobile" is statutorily defined in terms almost identi-

[109] P.L. 98-369.
[110] Code §280F(a)(1) and (2).
[111] P.L. 99-44.
[112] Pre-TRA Code §280F(d)(5)(B). Thus, the definition excludes taxicabs, limousines operated by limousine services, ambulances, hearses, and delivery or moving vehicles. Temp. Regs. §1.280F-6T(b)(2) excludes special purpose farm vehicles such as tractors.
[113] Code §280F(b).
[114] P.L. 95-618.
[115] *See* §4064(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

cal to those used in the 1984 Act to define "passenger automobile." [116] The Secretary of the Treasury, however, was given regulatory authority to prescribe an alternate rate schedule for "small manufacturers." [117] The term "small manufacturer" is statutorily defined as any manufacturer which manufactures (whether or not in the United States) in the two preceding model years less than 10,000 automobiles, and can reasonably be expected to manufacture fewer than 10,000 automobiles in the current model year for which the fuel economy is being determined.[118]

B. Overview

The Tax Reform Act of 1986 enacts technical amendments to the Tax Reform Act of 1984 with respect to the definition of "passenger automobile" in connection with both the §280F restrictions on recovery deductions and the imposition of the gas guzzler tax. The amendments clarify that the maximum weight for such vehicles is the gross unloaded weight, meaning that they are to be weighed without passengers or cargo. This does not apply, however, with respect to trucks and vans which would otherwise be included in the definition of passenger automobile. The gas guzzler tax is also amended to exempt small manufacturers which lengthen existing automobiles. The provisions relating to listed property are also modified to account for the leasing of such property (including computers) and to exclude from the listed property definition any property if substantially all of it is used in the trade or business of providing for hire to unrelated persons the transportation of persons or property.

C. Detailed Analysis

1. Passenger Automobile Definition

For purposes of the limitation on the investment credit and depreciation on luxury automobiles, the 1986 TRA modifies the definition of "passenger automobile" in §280F so that the term now refers to any 4-wheeled vehicle which is manufactured primarily for use on public streets, roads and highways and is rated at 6,000 pounds unloaded gross vehicle weight or less.[119] The change to *unloaded* gross vehicle weight clarifies the intent of the 1984 TRA that defining the term by reference to the weight of the automobile should not include the weight of the passengers or the weight of any cargo. However, the existing definition ("6,000 pounds gross vehicle weight or less") is retained for trucks and vans.[120]

The same clarification of the definition of passenger automobile is made with respect to the "gas guzzler" tax under §4064.[121] A transition rule, advanced by General Motors, exempts station wagons if the station wagon was a 1985 or 1986 model manufactured before November 1, 1985 and is originally equipped with more than 6 seat belts.[122] Moreover, an exception is made if the manufacturer under §4064 is a small manufacturer and would be treated as a manufacturer for purposes of the gas guzzler tax solely because it lengthens an existing automobile in a model year in which it is a small manufacturer. This exemption excepts the small manufacturer from the definition of "manufacturer" for purposes of imposing the gas guzzler tax.[123] The amendment for small manufacturers which lengthen existing automobiles applies as if made included in the amendments made by §201 of Public Law 95-618 (the gas guzzler provisions of the Energy Tax Act of 1978).[124] The luxury automobile and gas guzzler tax clarifications are effective as if included in the provision of the Tax Reform Act of 1984 to which the amendment relates.[125]

Note: The limits on automobile depreciation are also changed by the 1986 Act. Thus, for cars costing more than $12,800, the first year limit on deductions is $2,560, with varying amounts thereafter. For a more detailed analysis see Chapter 4, *supra*.[126] The investment tax credit was repealed generally for property placed in service after December 31, 1985 in taxable years ending after that date.[127]

2. Listed Property

The 1986 TRA clarifies the listed property requirements in three respects. First, the scope of use in a trade or business for purposes of determining the allowable investment credit or recovery deduction for listed property is expanded to include any deduction allowable to the employee for rentals or other payments under a lease of the listed property.[128] This is in addition to the existing requirements that the use of the listed property be both for the convenience of the employer and required as a condition of employment.

The exception from the definition of the term "listed property" which is provided for any computer or peripheral equipment used exclusively at a regular business establishment is clarified by the 1986 TRA to require that the computer or equipment also be owned or leased by the person operating the business establishment.[129] Thus, where an employee uses his own computer in the office, he will not be entitled to the deductions for depreciation. In the context of the conference report to the 1984 TRA, this restriction also applies to computers and peripheral equipment

---

[116] Code §4064(b)(1)(A) defines "automobile" as any 4-wheeled vehicle propelled by fuel which is manufactured primarily for use on public streets, roads or highways (but not exclusively on rails) and which is rated at 6,000 pounds gross vehicle weight or less.

[117] Code §4064(d).

[118] Code §4064(d)(4)(A)(i) and (ii).

[119] Act §1812(e)(1)(A), amending Code §280F (d)(5)(A)(ii).

[120] Act §1812(e)(1)(C), amending Code §280F (d)(5)(A) by adding a new sentence which substitutes the phrase "gross vehicle weight" for "unloaded gross vehicle weight" where a truck or van is involved. See also S. Rep. No. 313, 99th Cong., 2d Sess. 963 (1986).

[121] Act §1812(e)(1)(B)(i), amending §4064(b)(1)(A)(ii).

[122] Act §1812(e)(B)(iii). *See also* H.R. Rept. No. 426, 99th Cong., 1st Sess. 943 (1985).

[123] Act §1812(e)(1)(B)(ii), amending Code §4064 (b)(5)(B)(i) and (ii).

[124] Code §4064(b)(5)(B)(iii) as amended by Act §1812(e)(1)(B)(ii).

[125] Act §1881.

[126] Act §201(d)(4), amending Code §280F(a)(2). The subsequent limitations are $4,100 in the second year, $2,450 in the third year, and $1,475 in the fourth and subsequent years.

[127] Act §211.

[128] Act §1812(e)(2), amending Code §280F(d)(3) by adding the parenthetical "(or the amount of any deduction allowable to the employee for rentals or other payments under a lease of listed property)" after "recovery deduction allowable to the employee."

[129] Act §1812(e)(3), amending Code §280F(d)(4).

used in a home office which is used as a regular business establishment.[130]

The definition of "listed property" is also clarified with respect to that portion of the definition which includes "any other property used as a means of transportation". This definition is amended to exclude property if substantially all of its use is in the business of providing services consisting of the transportation of persons or property for hire to unrelated persons.[131]

A clerical amendment is also enacted which revises §280F(d)(2) to make it clear that if less than 100% of the use of any listed property during any taxable year is use described in §168(c)(1) then all use is treated as use described in §168(c)(1).[132]

The listed property modifications generally take effect as if included in the provision of the Tax Reform Act of 1984 to which it relates.[133]

XI. Demolition Loss Effective Date Clarification

A. Introduction

The Tax Reform Act of 1984 extended the disallowance of demolition expenses and losses under Code §280B to all structures on a permanent basis, effective with respect to taxable years beginning after December 31, 1983.[134] Before this change, §280B had only denied these deductions to an owner or lessee of a certified historic structure and the law was due to expire in connection with demolitions commenced after December 31, 1983.

The legislative history to the 1984 TRA called for the disallowance moratorium to extend to demolitions commencing after December 31, 1983.[135] The Conference Report purportedly followed the Senate bill;[136] however, the actual law passed was effective for *taxable years* beginning after December 31, 1983.[137] Thus, the key focus became the taxable year instead of the demolition. As a result, a "window" was created whereby a taxpayer could take deductions for demolition expenses and losses, including those attributable to certified historical structures, occurring after December 31, 1983, but prior to the end of the taxpayer's taxable year.

B. Effective Dates Clarified

In a technical correction, the Tax Reform Act of 1986 amends the effective date section of the Tax Reform Act of 1984 relating to the permanent disallowance of the deduction for demolition expenses of certain structures. The technical correction contained in the 1986 TRA makes the 1984 amendments effective for taxable years ending after December 31, 1983, but not for any demolition of a structure other than a certified historic structure, if that demolition commences before July 19, 1984 (the day after the date the 1984 TRA was enacted).[138] The correction also provides that where demolition is delayed until the completion of its replacement structure on the same site, the demolition is to be treated as commencing when construction of the replacement structure begins.[139] However, a Senate proposal which would have allowed the unrecognized basis in specific demolished structures to be allowed as an ordinary deduction in the year of demolition was defeated.

One of two transition rules concerns demolition of an Ethyl Corporation lead alkyl antiknock product facility in Baton Rouge, Louisiana.[140] The other concerns an unspecified bank headquarters building demolition.[141]

This amendment is effective as if included in the provision of the Tax Reform Act of 1984 to which it relates.[142]

---

[130] *See* H.R. Rept. 98-861 1026 (1984)(the Conference Report to the 1984 Act), cited in S. Rept. at 963.

[131] Act §1812(e)(4) amending Code §280F (d)(4) by adding a new subparagraph (C).

[132] Act §1812(e)(5), clarifying Code §280F(d)(2) by striking out "is not use described in" and replacing it with "is use described in".

[133] Act §1881.

[134] §1063(a) of the Tax Reform Act of 1984, P.L. 98-369.

[135] Senate Report (H.R. 4170) 98th Cong., 2d Sess. (1984), §879. *See also* Explanation of Senate Finance Committee issued April 2, 1984, at 893-894.

[136] *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 1273 (1984).

[137] §1063(c) of the Tax Reform Act of 1984.

[138] Act §1878(h), amending §1063(c) of the 1984 Act.

[139] *Id.*, adding new §1063(c)(2) of the 1984 Act.

[140] *Id.*, adding new §1063(c)(3) of the 1984 Act.

[141] *Id.*, adding new §1063(c)(4) of the 1984 Act.

[142] Act §1881.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 9

MODIFICATION OF CERTAIN NON-BUSINESS DEDUCTIONS

John Freeman Blake, Esq.
Jerry J. McCoy, Esq.
Silverstein and Mullens
Washington, D.C.

I. Two-Earner Married Couple Deduction Repealed [Act §131]

Pre-1986 TRA Code §221 provided married couples who file a joint return a deduction against income where both spouses work. The deduction was introduced in 1981 to reduce the inequity caused by combining two incomes for income tax purposes. The deduction equaled 10% of the lesser of the earned income of the lower-earning spouse or $30,000. Therefore, the maximum deduction was $3,000.

Act §131 repeals the deduction for two-earner married couples.

The rationale for repealing this provision is that, in light of lower tax rates, the higher standard deduction and larger personal exemptions, the deduction is no longer necessary. However, repeal of this provision will result in some inequity for married couples. For example, if both the husband and the wife earn $30,000 in 1988, have no other income, no deductions, no dependents, and file a joint return, they will pay a federal income tax (ignoring the standard deduction and personal exemptions) of $12,932.50. If the same couple were taxed separately as single taxpayers, each one would pay a tax (again ignoring the standard deduction and personal exemption) of $6,079.50, for a combined tax of $12,159.00. Therefore, the married couple pay an extra tax of $773.50 based solely on their status as a married couple. If the Act had retained the two-earner deduction, the couple's joint return tax would be reduced to $12,092.50—$66.50 less than the combined tax of two single taxpayers.

The repeal is effective for taxable years beginning after December 31, 1986.[1]

II. Deduction for Adoption Expenses Repealed [Act §135]

Pre-1986 TRA Code §222 provided for a limited itemized deduction for expenses of adoption expenses incurred in adopting a child with special needs. A child with special needs is one who is handicapped or who qualifies for adoption assistance payments under the Social Security Act. The deduction was limited to $1,500 of adoption expenses.

Act §135 repeals the adoption expense deduction. This provision is not primarily a revenue raiser. Instead, it reflects Congressional intent to reduce the role of the Code in social policy issues. The House Ways and Means Committee Report states that assistance to families adopting children with special needs is more appropriately accomplished through direct expenditures.[2]

Coinciding with the repeal of the adoption expense deduction, the Act, §1711, amended the Adoption Assistance Program of Title IV-E of the Social Security Act to provide federal matching funds to states, for financial assistance to adopting parents. The types of expenses eligible for matching funds under Act §1711 are the sort that were formerly deductible under Code §222. According to House Ways and Means Committee projections, the revenue gains resulting from the repeal of the deduction will be offset entirely by the new expenditures that will be made under the expanded Social Security Act program.[3]

The repeal of the adoption expense deduction and the commencement of the matching funds program under the Social Security Act are both effective for taxable years beginning after December 31, 1986.[4]

III. Floor Under Medical Expense Deduction Increased [Act §133]

Code §213 allows taxpayers who itemize deductions to deduct unreimbursed medical care expenses to the extent that the total of such expenses exceeds 5% of adjusted gross income.

Act §133 increases the floor above which medical expenses are deductible from 5% of adjusted gross income to 7.5%. The increased floor was designed to reduce the number of taxpayers claiming the deduction. It is believed that the deduction creates unnecessary complexity in the tax system. Yet, for compassionate reasons, it was decided that the deduction should be retained for those taxpayers whose medical expenses are truly extraordinary. Therefore, rather than repealing the deduction entirely, the Act increased the floor above which expenses must total before they become deductible.

The increase in the floor for medical expense deductions is effective for taxable years beginning after December 31, 1986.[5]

---

[1] *See* Act §151(a).

[2] H.R. Rep. No. 426, 99th Cong., 2d Sess. 113 (1985)("House Report").

[3] *Id.*

[4] Act §151(a) and §1711(d).

[5] Act §151(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Note: The medical expense deduction is one of the few itemized deductions allowed by §56(b)(1) in computing an individual's alternative minimum tax after 1986. However, in computing the amount allowable for minimum tax purposes, the 7.5% adjusted gross income floor is raised to 10%.

IV. Deduction for State and Local Sales Taxes Repealed [Act §134]

Pre-1986 TRA Code §164 provided an itemized deduction for state and local income, property, sales and other taxes.

Act §134(a)(1) repeals the portion of §164 that provided for an itemized deduction for state and local sales taxes. Other state and local taxes continue to be deductible to the extent that they were deductible under pre-1986 TRA law.

Under Act §134(a)(2), the amount of the state or local sales tax attributable to property acquired in a trade or business or for investment is to be added to the basis of the property, or if paid by the seller, as a reduction of the amount received for the property.

The repeal of state and local sales taxes is consistent with a general goal of the Act to apply a reduced tax rate to a broader income base. Achieving this goal requires the Code to allow fewer itemized deductions. The repeal is also consistent with the general tax policy to deny deduction for personal consumption as opposed to business expenses. Domestic sales taxes, like interest payments on loans, have been deductible whether they stemmed from purchases of personal goods or material for trade or business. Foreign sales taxes, by contrast, can be deducted only if they are paid or accrued in carrying on a trade or business or an activity for profit.[6] The purpose of the provisions of the Act has been to treat sales taxes in conformity with the overall policy of the Code, by denying the deduction for personal expenses and treating those involving business or investment activities in a manner consistent with that of other costs of capital assets.

Another policy consideration favoring the repeal of the deduction is the widespread inconsistency with which sales taxes were treated under previous law. Taxes on certain items, such as alcoholic drinks, tobacco, gasoline and utility services, were not deductible. Corresponding taxes paid at the wholesale and manufacturing levels were also nondeductible. Further, the existed some inconsistency in the treatment of other sales taxes under the regulations for Code §164; taxes which were not imposed at the same rate on all transaction or which were construed as selective or imposed solely on services were denied deductibility.[7]

To some extent denial of the deduction might be viewed as regressive. This is because lower income taxpayers necessarily spend a greater portion of their income on personal expenditures. A deduction for consumption sales taxes against income taxes eases the tax burden of lower income taxpayers. However, lower income taxpayers are the least likely to itemize deductions. Therefore, little regressivity should result from the denial of the deduction.

During legislative debate on the Act, state and local authorities argued that denial of the deduction would create unfairness for taxpayers living in jurisdictions that rely heavily on a sales tax in lieu of other taxes. Alternatively, it was argued that denial of the sales tax deduction might encourage state and local governments to shift the tax burden to other, deductible, taxes. However, the Act reflects a Congressional judgment that no unwarranted unfairness will result, because only a small part of the general sales tax is claimed as a deduction by federal taxpayers.[8]

Elimination of the deduction is likely to make it more difficult for state and local governments to raise sales taxes because they can no longer argue that the burden of the increased tax is lessened by the federal income tax deduction.

Taxpayers who did not use the optional federal tables for computing the deduction for state and local sales tax have had to keep detailed and cumbersome records to substantiate a sales tax deduction. Elimination of the deduction can therefore be seen, in part, as an effort to reduce complexity in the tax system.

The repeal of the state and local sales taxes is effective for taxable years beginning after December 31, 1986.[9]

Observation: State, local and foreign real property taxes, state and local personal property taxes, and state, local, and foreign income taxes remain deductible under §164(a) for regular tax purposes after 1986 as itemized deductions. However, these taxes are disallowed by §56(b) for purposes of the alternative minimum tax if allowed only as itemized deductions for regular tax purposes.

V. Impact of Certain Housing Allowances on Mortgage Interest and Property Tax Deductions [Act §144]

While the Internal Revenue Code has no specific code section dealing with this rule, the Service ruled in Rev. Rul. 83-3 [10] that a minister who received a parsonage allowance that is excludable from gross income under §107 could not deduct the interest or property taxes incurred in owning the house. Although the ruling spoke specifically about parsonage allowances for ministers, the same situation arises for military personnel whose housing allowances are also excludible from gross income.[11] Therefore, the conclusions reached by Rev. Rul. 83-3 could be seen as having far broader application.

The rationale for denying deductions in this context comes from Code §265(l) (now §265(a)(1), which denies a deduction for interest expenses incurred to generate tax-exempt income. The purpose of Code §265 is to prevent a double tax benefit that results from deducting expenses related to items that are themselves excluded from taxable income. Rev. Rul. 83-3 argued that since the housing allowance was itself excludible under Code §107, expenses related to the house that would otherwise be deductible such as mortgage interest and property taxes would not be allowed as deductions. Although this aspect of the ruling

[6] §164(a).
[7] Regs. §1.164-3(g)(1).
[8] S. Rep. No. 313, 99th Cong., 2d Sess. 56 (1986)("Senate Report").
[9] Act §151(a).
[10] Rev. Rul. 83-3, 1983-1 C.B. 72.
[11] Regs. §1.61-2(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

has not been challenged in court, another aspect of the ruling dealing with the analogous situation of excludible veterans education benefits and the deduction for education expenses has been challenged. In this latter context, the Tax Court has upheld the validity of the ruling.[12]

Act §144 overrules that portion of Rev. Rul. 83-3 that deals with expenses related to tax-exempt housing allowances. The repeal is accomplished by adding §265(6), which provides that §265 is not to be used to deny the deduction for mortgage interest or property taxes by reason of the taxpayer receiving either a military housing allowance or a parsonage allowance, both of which continue to be excludible from gross income.

This section of the Act is surprising in the sense that it is one of the Act's few pro-taxpayer provisions. It provides substantial relief to those taxpayers affected by it. Its application to military personnel makes it a significant provision in terms of the numbers of taxpayers affected.

Act §151(e) states that the amendment made by Act §144 "shall apply to taxable years beginning before, on, or after, December 31, 1986." In effect, this means that Act §144 is effective from the date of the issuance of Rev. Rul. 83-3 in 1983, reversing the impact of the ruling from its issuance.

VI. Deduction for Non-Business Casualty Losses Clarified [Act §1004]

Code §165(h) provides for a limited itemized deduction for casualty losses incurred by individuals not in connection with a trade or business. Personal casualty losses are allowed only if they arise from "fire, storm, shipwreck, or other casualty or theft." In addition, personal casualty losses are deductible only to the extent each loss exceeds $100, and only to the extent that all casualty losses for the year exceed 10% of the taxpayer's adjusted gross income. Finally, personal casualty losses are allowed as a deduction only to the extent that the loss is not reimbursed by insurance.

For some taxpayers, the value of the tax deduction is greater than the reimbursement from insurance. For other taxpayers, there is a risk that filing a claim for a loss will cause the insurance company to raise insurance rates or to cancel the policy. Some would argue that, to the extent of the insurance coverage that could have been recovered, the taxpayer has not sustained the loss by reason of the casualty, but rather has sustained the loss by reason of the voluntary decision not to file the claim.

Based upon this argument, the Service has taken the position that the casualty loss deduction is limited to the amount that exceeds what could have been recovered if the taxpayer had filed an insurance claim. However, some courts have ruled that the Code does not limit the taxpayer's deduction in this manner.[13]

Act §1004(a) adds subparagraph (4) to Code §165(h), providing that if a taxpayer has insurance that covers the loss, the taxpayer must file a timely claim for the loss as a prerequisite to taking any deduction for the loss.

This change is effective for losses sustained in tax years beginning after December 31, 1986.[14]

VII. Two Percent Floor Under Miscellaneous Itemized Deductions [Act §132]

A. Pre-1986 TRA Law

Prior law provided itemized deductions referred to as "miscellaneous deductions." Miscellaneous deductions include the following: (i) unreimbursed employee business expenses (other than those deductible "above-the-line"), including union and professional dues (Code §162(a)), and home office expenses of an employee (Code §280A); (ii) certain expenses related to investment income or property (such as attorneys fees, financial planning fees, investment counsel fees) if deductible under Code §212; (iii) tax return preparation costs and related expenditures if deductible under Code §212(3); (iv) gambling or hobby losses up to the amounts of gambling or hobby income (Code §§165(d) and 183); (v) certain adjustments where a taxpayer restores amounts held under claim of right (Code §1341); (vi) amortizable bond premiums (Code §171); and (vii) certain costs of cooperative housing corporations (Code §216).[15]

B. Changes Made by the Tax Reform Act of 1986

1. In General

Act §132(a) enacts Code §67, effective for tax years beginning after December 31, 1986, which imposes a new floor to the deduction of miscellaneous itemized deductions. Under the Act, miscellaneous itemized deductions are allowable only to the extent that they exceed 2% of adjusted gross income. The purpose of imposing the floor is to reduce the tax benefit of taking miscellaneous deductions and to reduce the number of taxpayers claiming the deduction. Therefore the floor is in line with two overall goals of the Act, to broaden the tax base by reducing the number of available deductions and to simplify the tax system.

Post-1986 TRA Code §67(b) defines the term "miscellaneous itemized deductions" to mean all itemized deductions *other than* deductions for the following items:

(i) Interest allowed under Code §163 (for new limitations on the deductibility of interest expenses, *see* Chapter 5);

(ii) State and local taxes deductible under Code §164 (to the extent they continue to be deductible under the Act; *see* IV, *supra);*

(iii) Personal casualty losses described in Code §165(c)(3) and gambling losses described in Code §165(d);

(iv) Charitable contributions deductible under Code §170;

(v) Medical expenses deductible under Code §213 (to the extent they continue to be deductible under the Act; *see* III, *supra*);

[12] *Kendel v. Comr.*, 50 T.C.M. 1279 (1985); *Becker v. Comr.*, 85 T.C. 291 (1985); and *Allen v. Comr.*, 51 T.C.M. 427 (1986).

[13] *Cf. Hills v. Comr.*, 691 F.2d 997 (11th Cir. 1982); *Miller v. Comr.*, 733 F.2d 399 (6th Cir. 1984).

[14] Act §1004(b).

[15] Conference Report on H.R. 3838, H.R. Rep. No. 514, 99th Cong. II-32.

(vi) Moving expenses deductible under Code §217;

(vii) "Impairment-related work expenses;"

(viii) Estate tax attributable to income in respect of a decedent deductible under Code §691(c);

(ix) Any deduction allowable in connection with personal property used in a short sale;

(x) Amounts incurred where a taxpayer restores an amount held under a claim of right under Code §1341;

(xi) Amounts deductible where annuity payments cease prior to recovery of investment in the contract under Code §672(b)(3);

(xii) Amortizable bond premiums deductible under Code §171; and

(xiii) Certain expenses relating to cooperative housing corporations deductible under Code §216.

Impairment-related work expenses (vii *supra*) are defined in Act §132(a) (Code §67(d)) to refer to expenses for attendant care services and other expenses necessarily incurred in order for a handicapped individual to be able to work. A handicapped person is defined by reference to Code §190(b)(3) as a person who has a physical or mental disability that results in a functional limitation to employment or which limits one or more life activities.

A short sale (ix *supra*) is a transaction in which the taxpayer sells stock which he does not own. In order to engage in the sale, the taxpayer borrows the required stock certificates. Later, the taxpayer must acquire new shares to replace the borrowed security. The taxpayer realizes a gain on the transaction if the replacement stock can be acquired at a lower price than the price at which the initial sale was made. A taxpayer realizes a loss on the transaction if the replacement stock costs more than the price received on the sale. The deduction for any loss on the transaction is a capital loss (long-term or short-term) and is subject to the limitation under Code §1211 for deduction of capital losses. Because these losses are governed by Code §1211, they are not further limited by the 2% floor applicable to miscellaneous deductions.

Restoration of amounts held under a claim of right (x *supra*) takes place if, after the taxable year, it is determined that the taxpayer was not entitled to keep property previously received. For example, if a taxpayer received a bonus based upon a formula and it later turned out that the computation had been incorrectly made, the taxpayer might be required to repay some or all of the bonus. If the taxpayer has already paid tax on the item in the prior year, he is eligible to take a deduction to compensate for this overpayment of tax. Any deduction allowed under these circumstances is allowed without regard to the 2% floor applicable to miscellaneous deductions.

All itemized deductions not listed in the above list are subject to the new 2% floor. This includes business expenses incurred by an employee to the extent these deductions are allowable only as an itemized deduction. Those employee business expenses allowed "above-the-line" in arriving at adjusted gross income are not subject to the 2% floor; *e.g.*, employee expenses reimbursed by the employer, expenses for travel while away from home, transportation expenses, business expenses of outside salespersons, and moving expenses to the extent allowed by Code §217.[16]

By defining miscellaneous deductions to include all deductions other than certain specified deductions, the Act leaves open some discrepancies as to the treatment of certain types of deductions. Specifically, charitable deductions from a trust or estate under Code §642(c) are not included in the above list. Therefore, although an individual charitable deduction under Code §170 is exempt from the 2% floor, a similar trust deduction is subject to it. In addition, the distribution deduction allowed to trusts and estates under Code §651(a) or 661(a) is also missing from the above list.

These results were not intended. House Resolution 395, which would have corrected numerous omissions and typographical errors in the Act, would have corrected each of these obvious omissions. However, the House Resolution never passed Congress and the President signed the bill with the errors included.

Code §67(c) directs the Service to issue regulations to prevent the 2% floor from being circumvented by deducting the expense in a passthrough entity, such as a partnership, S corporation or mutual fund, but not including such passthrough entities as estates, nongrantor trusts, cooperatives, and REITs. These regulations are to include such reporting requirements as may be necessary to carry out the intent of this provision.

2. Estates and Trusts

In the case of an estate or trust, Code §67(e) provides that the adjusted gross income is to be computed in the same manner as for an individual, except that the deductions for costs paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in the trust or estate are treated as allowable in arriving at adjusted gross income. As a result of this treatment, these costs are not subject to the 2% floor.

However, it is uncertain what is included in the phrase dealing with expenses which *would not have been incurred* if the property were not held in an estate or a trust. This phrase might be read to refer to all trustee and administrative fees. However, trustee fees are normally set at a rate that compensates the trustee for many types of services: administration services, custodial services and investment advice. Not all of these services represent services that would not have been incurred but for the fact that the property was held in trust. In particular, it appears that the portion of a trustee's fee allocable to investment advice might not be exempt from the floor because it is not an expense that would not have been incurred *but for* the fact that the property was held in trust. This analysis suggests that a trustee will have to make an allocation between that portion of the fee covered by the 2% floor (investment advice) and the portion exempt from the 2% floor (administrative services).

[16] Under the Act, moving expenses are no longer treated as "above-the-line" deductions and instead become itemized deductions. However, since moving expenses are subject to their own limitations, under §217, they are not subject to the 2% floor.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

However, the purpose of the trust and estate exception appears to be an effort to simplify the administration of trusts. If so, the very purpose of this exception is to avoid the necessity of making these types of allocations. It is unclear how this controversy will be resolved. Unless the issue is clarified in a future technical corrections act, it may take a court decision to define the intent of its portion of Act §132.

3. Special Rule for Actors and Performing Artists

Act §132(b) enacts Code §62(a)(2)(B). This new section contains a special rule for the employment-related expenses of an actor or other performing artist. Under this section, a "qualified performing artist" is allowed a new above-the-line deduction for employee business expenses allowable under §162 during a year if the performing artist for that year (i) had more than one employer (excluding any nominal employer[17]) in the performing arts, (ii) incurred allowable §162 expenses in connection with performing services as an employee in an amount exceeding 10% of gross income from the services, and (iii) did not have adjusted gross income, as determined before deducting such expenses, exceeding $16,000. For married couples filing a joint return, items (i) and (ii), above, are applied separately as to each spouse, but item (iii) is applied to the couple with respect to their combined adjusted gross income.[18]

4. Effective Date

The changes made by Act §132 are effective for taxable years beginning as of December 31, 1986.[19]

VIII. Augmented Charitable Deduction for Donation of Scientific Equipment

A. Overview

In general, Code §170(e)(1)(A) limits the amount of the deduction for charitable contributions of inventory property to the donor's basis, rather than the fair market value of the property. In 1981, however, Congress added §170(e)(4), providing a special rule for certain contributions by corporations to colleges and universities of appreciated property to be used for scientific research.

Act §231(f) expands the category of eligible donees under §170(e)(4) to include tax-exempt scientific research organizations.

B. Analysis

Under the general rule of §170(e) the deductible amount of a charitable contribution of inventory property is the fair market value of the contributed property, reduced by the amount of gain which would not have been long-term capital gain if the property had been sold by the taxpayer at its fair market value on the date of contribution.[20] The effect of this rule is to limit the donor's deduction for inventory property to such property's basis.

Section 170(e)(4), added to the Code in the Economic Recovery Tax Act of 1981, provides an augmented charitable deduction for corporate donations of newly-manufactured scientific equipment or apparatus to a college or university for research use in the physical or biological sciences. The provision contains a lengthy set of requirements for qualification. To qualify for the deduction, the following requirements must be satisfied:[21]

1. The contributed property must be tangible personal property of the type described in §1221(1) (*i.e.*, stock in trade, inventory property, or property held primarily for sale to customers in the ordinary course of business);[22]

2. The contribution must be made to an educational organization described in §170(b)(1)(A)(ii) which is also an institution of higher learning (as defined in §3304(f));[23]

3. The property must be constructed by the donor;[24]

4. The contribution must be made within two years after construction of the property is substantially completed;[25]

5. The donee must be the original user of the property;[26]

6. The property must be scientific equipment, substantially all the use of which by the donee is for research and experimentation (within the meaning of §174), or for research training, in the United States in physical or biological sciences;[27]

7. The donee must not transfer the property in exchange for money, other property or services;[28] and

8. The donor must receive from the donee a written statement representing that the use and disposition of the property will comply with requirements 6. and 7., *supra*.[29]

If all these conditions are met, a deduction is generally allowable equal to the sum of the taxpayer's basis in the property plus half of the unrealized appreciation. In no event, however, is a deduction allowable for more than twice the taxpayer's basis in the property.[30]

Section 231(f) of the 1986 Act extends the expanded deduction by amending §170(e)(4)(B)(i) (the second requirement in the foregoing list) to include an additional category of permissible donee. This category consists of scientific research organizations of the type described in new §41(e)(6)(B). These are organizations which: (1) are not educational institutions of higher learning (although such organizations continue to qualify independently as donees for such contributions); (2) are described in §501(c)(3) and exempt from tax under §501(a); (3) are organized and operated primarily to conduct scientific re-

[17] A nominal employer is one that pays the qualified performing artist less than $200 during the taxable year. Code §62(b)(2).
[18] §62(b)(3).
[19] Act §151(a).
[20] §170(e)(1)(A).
[21] *See* §170(e)(4)(B), defining "qualified research contributions."
[22] §170(e)(4)(B).
[23] §170(e)(4)(B)(i), prior to amendment by the 1986 TRA. As amended, §170(e)(4)(B)(i) cross-refers to §41(e)(6)(A).
[24] §170(e)(4)(B)(ii).
[25] §170(e)(4)(B)(iii).
[26] §170(e)(4)(B)(iv).
[27] §170(e)(4)(B)(v).
[28] §170(e)(4)(B)(vi).
[29] §170(e)(4)(B)(vii).
[30] *See* §170(e)(4)(A), referring to §170(e)(3)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

search; and (4) are not private foundations as defined in §509(a).[31]

C. *Effective Dates*

The expanded deduction is applicable for taxable years beginning after December 31, 1985. Act §231(g)(1).

D. *Planning Suggestions*

This enlargement of the category of donees qualified for the expanded deduction offers additional planning opportunities for corporations whose activities include the construction of property subject to §170(e)(4). Formerly, only colleges and universities were permissible donees. While colleges and universities often maintain close relationships with corporations, such institutions are inherently independent organizations. By contrast, the 1986 Act permits expanded deductions for contributions to an organization which can be much more closely allied with the donor-corporation itself.

So long as a scientific research organization avoids private foundation status, it can qualify as a recipient of property qualified for an expanded deduction under §170(e)(4). For example, qualification might be possible for an organization which is affiliated with a university or other public charity (so as to qualify as a supporting organization under §509(a)(3), and hence avoid private foundation status), but not actually a part of such public charity. Another alternative might be an organization linked in a similar fashion to a §501(c)(6) trade association active in the physical or biological sciences. Section 509(a)(3) grants an exception from private foundation status to certain organizations of this type.[32] Such a linkage would only be feasible where the support of the trade association conformed to the requirements of §509(a)(2), but such an entity can often meet that test where its income comes primarily from membership receipts and other sources related to the organization's exempt function.

[31] *See* §41(e)(6)(B).

[32] *See* flush language at the end of §509(a). *See generally* 296 T.M., *Private Foundations - Definition and Classification.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 10

COMPUTATION OF TAXABLE INCOME AND TAX FOR NONCORPORATE TAXPAYERS

John Freeman Blake, Esq.
Lynn K. Pearle, Esq.
Silverstein and Mullens
Washington, D.C.

I. Computation of Taxable Income: Standard Deduction and Personal Exemption [Act §§102, 103]

A. Overview

The Tax Reform Act of 1986 (the Act) has as a major goal the lowering of tax rates applicable to all taxpayers. To accomplish this, the Act broadens the taxable income base by reducing the items of income that are exempt from tax or specially treated under the Code. A secondary goal of the Act is to remove low income wage-earners from the tax roles and simplify the computation of tax for the majority of taxpayers.

The Act accomplishes this second goal by increasing the standard deduction, the personal exemption and the exemption for dependents. The increases in these items are phased in gradually over the next few years.

The standard deduction is available to all taxpayers who do not elect to itemize deductions. An election to itemize deductions would be made only if the total of all itemized deductions exceeded the dollar amount of the applicable standard deduction.

The personal exemption is designed to benefit low income taxpayers. The Act limits the benefit of the personal exemption by phasing it out for taxpayers whose taxable incomes reach a certain threshold level.

B. Standard Deduction

1. Pre-TRA 1986 Law

Pre-TRA 1986 law referred to the standard deduction as a "zero bracket amount" (ZBA). The following ZBAs apply for 1986 and reflect an adjustment for 1985 inflation.

Filing Status	*ZBA*
Joint returns and surviving spouses	$3,670
Heads of household	2,480
Single individuals	2,480
Married individuals filing separately	1,835

The ZBA is adjusted annually for changes in the consumer price index.[1]

[1] *See* 1954 Code §63.

A child eligible to be claimed as a dependent on his or her parents' return may use the ZBA only to offset earned income.[2] Thus, a child with unearned income exceeding the personal exemption amount must file a return and pay tax on the excess (reduced by any allowable itemized deductions).

2. Changes Made by the Tax Reform Act of 1986

a. 1987

For individual taxpayers other than elderly or blind individuals, the standard deduction amounts for taxable years beginning in 1987 are as follows:[3]

Filing Status	*Standard Deduction*
Joint returns and surviving spouses	$3,760
Heads of household	2,540
Single individuals	2,540
Married individuals filing separately	1,880

For elderly or blind individuals, the standard deductions listed in b., *infra*, are applicable in 1987—one year earlier than they are for other taxpayers.

b. 1988 and Later Years

The Act increases the standard deduction to the following amounts, effective for tax years beginning in 1988:[4]

Filing Status	*Standard Deduction*
Joint returns and surviving spouses	$5,000
Heads of household	4,400
Single individuals	3,000
Married individuals filing separately	2,500

Beginning in 1989, these increased standard deduction amounts are to be adjusted for inflation.[5] The method of

[2] *See* 1954 Code §63(e)(1)(D).
[3] Act §102(a), revising Code §63(h).
[4] *See* Act §102(a), revising Code §63(c).
[5] *See* Act §102(a), revising Code §63(c)(4); and Act §101(a), revising Code §1(f)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

computing the inflation adjustment is described, *infra*, under the heading, "E. Adjustment for Inflation."

The increased standard deduction, coupled with lower tax brackets and larger personal exemptions, represents significant tax reduction for lower income taxpayers. For example, in 1986, a married couple filing a joint return showing $15,000 of adjusted gross income will receive the advantage of a ZBA of $3,670. Assuming the couple has no other dependents, they will report two personal exemptions for $1,080 each (total of $2,160). They will pay a tax of $1,170.50. The couple's marginal tax bracket on additional income is 16%. In 1988, the same couple will have a standard deduction of $5,000 and two personal exemptions of $1,950 (total of $3,900). The couple's tax will be $915, a reduction of $255.50 over the 1986 tax. The couple's marginal tax bracket on additional income will be 15%. By 1989, when the higher personal exemption of $2,000 is fully phased in, the couple's tax will be $900, representing a $270.00 reduction over the 1986 tax.

c. Additional Standard Deduction for the Elderly and Blind

In addition to the regular standard deduction, there is an additional standard deduction allowed to blind and elderly individuals.[6] This increased standard deduction replaces the additional personal exemptions allowed to the elderly and the blind under pre-TRA law.

Under the Act, as under pre-TRA law, a person age 65 or older on the last day of the taxable year is eligible for the additional standard deduction for the elderly.[7] Also as under pre-TRA law, the Act defines blindness as central visual acuity that does not exceed 20/200 in the better eye with correcting lenses, or if greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.[8]

The new additional standard deduction for the elderly and the blind is $600 for a taxpayer who is married (whether filing jointly or separately) or is a surviving spouse ($1,200 for a taxpayer who is both elderly and blind). The additional standard deduction is $750 for an elderly or blind individual who is either unmarried or is not a surviving spouse ($1,500 for a taxpayer who is both elderly and blind). For elderly or blind taxpayers only, the standard deduction amounts listed above for 1988 and the additional $600 or $750 standard deduction amounts are effective beginning in 1987.[9] Beginning in 1989, the $600 and $750 additional standard deduction amounts will be adjusted for inflation.[10] The method of computing the inflation adjustment is described, *infra*, under the heading, "E. Adjustment for Inflation."

It appears that the additional standard deduction for the elderly and blind, when coupled with lower tax rates and a larger standard deduction, results in lower taxes despite the loss of the additional personal exemption allowed under pre-TRA law. In 1986, a single taxpayer who is both elderly and blind and has adjusted gross income of $15,000 will pay a tax of $1,317.50. In 1988, the same taxpayer will pay a tax of $1,282.50, a reduction of $35 over the 1986 tax.

d. Limitation on Standard Deduction for Certain Individuals

For individuals claimed as dependents on the return of any other taxpayer, the standard deduction is limited to the greater of $500 or the individual's earned income for the year.[11] This is discussed *infra* in "D. Rules for dependents."

The following taxpayer's are not entitled to any standard deduction:[12]

1. a married individual filing a separate return, where one spouse itemizes deductions;

2. a nonresident alien individual;

3. an individual making a return for a period of less than 12 months because of a change in annual accounting periods; or

4. estates or trusts, common trust funds or partnerships.

C. Personal Exemptions

1. Pre-TRA Law

For 1986, the personal exemption amount for an individual, the individual's spouse, and each dependent is $1,080. One additional personal exemption is provided for a taxpayer who is age 65 or older, and for a taxpayer who is blind.[13]

Each taxpayer may claim a personal exemption for himself or herself and for a dependent child (or other dependent) whose gross income does not exceed the personal exemption amount ($1,080 for 1986). In addition, parents may claim a personal exemption for a dependent child who has income exceeding the personal exemption amount if the dependent child is under age 19 or a full-time student. The child or other dependent also may claim a full personal exemption on his or her return.[14]

2. Changes Made by the Tax Reform Act of 1986

The Act increased the personal exemption for each individual, the individual's spouse, and each eligible dependent to the following amounts:[15]

Taxable Years	*Personal Exemption*
1987	$1,900
1988	1,950
1989	2,000

[6] *See* Act §102(a), revising Code §§63(c)(3) and (f).
[7] *See* 1954 Code §151(c); and Act §102, revising Code §63(f)(1).
[8] *See* 1954 Code §151(d)(3); and Act §102, revising Code §63(f)(4).
[9] *See* Act §102(a), revising Code §63(h).
[10] *See* Act §102(a), revising Code §63(c)(4); and Act §101(a), revising Code §1(f)(3).
[11] Act §102(a), revising Code §63(c)(5).
[12] *See* Act §102(a), revising Code §63(c)(6).
[13] *See* 1954 Code §151.
[14] *See* 1954 Code §§151-153.
[15] *See* Act §103(a), revising Code §151(f)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Beginning in 1990, the $2,000 personal exemption amount will be adjusted for inflation.[16] The method of computing the inflation adjustment is described, *infra,* under the heading, "E. Adjustment for Inflation."

The Act repeals the additional exemption for an elderly or blind individual, beginning in 1987.[17] The loss of the additional personal exemption for elderly or blind individuals is compensated for by the additional standard deduction provided by Act §102(a) for elderly or blind individuals, beginning in 1987.

3. Phase Out of Personal Exemptions

The personal exemption is designed primarily to provide tax relief for lower income taxpayers. As a result, beginning in 1988, the benefit of the personal exemption is phased out for taxpayers having taxable income exceeding specified levels. (Act §101(a)). The income tax liability of these taxpayers is increased by 5% of taxable income within certain ranges. Therefore, for taxpayers within the specified ranges, the marginal tax rate applicable to these taxpayers is 33% (5% more than the otherwise applicable rate of 28%).

This phase out is accomplished by a formula that first imposes a 5% surcharge on taxable income in excess of a specified amount, listed *infra,* and then imposes a limit on the amount by which a taxpayer's tax may be increased by the 5% surcharge.[18] The limitation for the phase out of the personal exemption only is 28% of the deductions for personal and dependent exemptions allowable to the taxpayer for the taxable year. For example, in 1988, the personal exemption is $1,950. Twenty eight percent of $1,950 is $546. Therefore, for each personal and dependent exemption, the 5% surcharge will continue to apply until it generates an additional $546 of tax. It takes an additional $10,920 of income to generate $546 of tax at 5%. Therefore, the effect of the phase out formula for personal exemptions is to keep a taxpayer in the 33% marginal tax bracket for an additional $10,920 of taxable income for each personal and dependent exemption claimed by the taxpayer.

In 1989, the personal exemption increases to $2,000. Twenty eight percent of $2,000 is $560. Therefore, in 1989, each personal and dependent exemption claimed will keep a taxpayer in the 33% marginal tax bracket for an additional $11,200 of taxable income. The phase out of the personal exemption begins at the taxable income level at which the benefit of 15% rate is totally phased out (*See* Chapter 10, II, *infra*). For 1988, those levels are as follows:

Taxpayer Filing Status	*Taxable Income*
Joint returns and surviving spouses	$149,250
Heads of household	123,790
Single individuals	89,560
Married individuals filing separately	113,300

The taxable income levels listed above are subject to adjustment for inflation in taxable years beginning in 1989.[19] The method of computing the inflation adjustment is discussed, *infra,* under the heading, "E. Adjustment for Inflation."

The phase-out of the tax benefit of each personal exemption occurs serially. That is to say, the phase out of the benefit of the second personal exemption on a joint return does not begin until the phase out of the first is complete. Thus, in the case of a married couple filing jointly who have two children, in 1988 the benefit of the four personal exemptions would phase out over an income range of $43,680 ($10,920 times four). The phase out would commence at $149,250, and would be complete at taxable income of $192,930 ($149,250 plus $43,680).

D. Rules for Dependents

The Act provides that no personal exemption amount is allowable on the return of an individual who is eligible to be claimed as a dependent on another taxpayer's return (for example, on the return of a child who is eligible to be claimed as a dependent on the return of a parent).[20]

As in the pre-TRA law rule that the ZBA may be used by such a dependent individual only to offset earned income, the Act provides that any amount of the standard deduction in excess of $500 may be used by a dependent individual only to offset earned income. For dependent taxpayers, the standard deduction is limited to the greater of the following: (a) $500 (to be adjusted for inflation beginning in 1989) or (b) the individual's earned income up to the basic standard deduction amount (in 1988, $3,000 for a single individual).[21] Therefore, a dependent must file a federal income tax return only if he or she has either gross income exceeding the standard deduction amount for the dependent child (*i.e.*, the greater of earned income or $500) or unearned income exceeding $500.

Therefore, if a single dependent has $800 of unearned income and no earned income, the standard deduction available to the dependent is $500. If a single dependent has $800 of unearned income and $1,000 of earned income, the standard deduction available to the dependent is $1,000. If a single dependent has $3,000 or more of earned income, the standard deduction available to the dependent in 1988 is $3,000.

E. Adjustment for Inflation

Beginning in 1989 and 1990, both the standard deduction and the personal exemption, respectively, are increased for inflation. (Act §§102(a) and 103(a)). In addition, inflation adjustments are made for tax rate brackets and the thresholds for determining to whom the 5% surcharge in tax rates apply (*See* Chapter 10, II, *infra*). The purpose of the adjustment is to prevent "bracket creep" in which a taxpayer's tax increases because of income increases that are made to keep the taxpayer abreast of inflation. A similar inflation adjustment applies to the tax brackets, zero bracket amount and personal exemptions applicable under pre-TRA law.[22]

[16] *See* Act §103(a), revising Code §151(f)(3).
[17] *See* Act §103(b).
[18] *See* Act §101(a), revising Code §1(g).
[19] *See* Act §101(a), revising Code §1(g)(4).
[20] *See* Act §103(a), revising Code §151(d)(2).
[21] Act §102(a), revising Code §63(c)(5).
[22] *See* 1954 Code §1(f).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The inflation adjustment is made with reference to the Consumer Price Index (CPI) for all-urban customers published by the Department of Labor for the 12-month period ending on August 31 of each year. The amount of the adjustment to be made each year is the percentage, if any, by which the CPI for the immediately preceding year exceeds the CPI for 1987.[23] In the event the computation results in a number which is not a multiple of $50, the number is rounded to the next lowest $50. In the case of adjustments for married persons filing separate returns, the number is rounded to the next lowest $25, rather than the next lowest $50.[24] Note that if the CPI were to decline in any one year, a downward adjustment would be required by this formula. However, if the CPI were to decline below the 1987 level, no further downward adjustments would be made.

II. Determination of Tax [Act §§101, 301, 302]

A. Pre-TRA Law

Under pre-TRA law, the rate structure for computing tax consists of up to 15 taxable income brackets and tax rates, beginning above the zero bracket amount (ZBA). (1954 Code §1).

For married individuals filing jointly and surviving spouses, there are 14 taxable income brackets above the ZBA of $3,670. The minimum 11% rate applies to taxable income above $3,670; the maximum 50% rate applies to taxable income above $175,250. For married individuals filing separate returns, the ZBA is one-half the ZBA on joint returns, and the taxable income bracket amounts are one-half the amounts for joint returns.

For taxpayers who qualify as heads of households, there are 14 taxable income brackets above the $2,480 ZBA. The minimum 11% tax rate applies to taxable income above $2,480; the maximum 50% rate applies to taxable income above $116,870.

For single individuals, there are 15 taxable income brackets above the $2,480 ZBA. The minimum 11% tax rate applies to taxable income above $2,480; the maximum 50% rate applies to taxable income above $88,270.

B. Changes Made by the Tax Reform Act of 1986

1. Tax Rates—1987

For taxable years beginning in 1987, a five bracket rate schedule is provided.[25] This schedule is shown on the following table. The special rules, discussed *infra,* for phasing out the benefit of the lower brackets do not apply for 1987.

Tax rate	*Married, filing joint returns*	*Heads of household*	*Single individuals*
11%	$ 0-$3,000	$ 0-$2,500	$ 0-$1,800
15%	3,001-28,000	2,501-23,000	1,801-16,800
28%	28,001-45,000	23,001-38,000	16,801-27,000
35%	45,001-90,000	38,001-80,000	27,001-54,000
38.5%	Over $90,000	Over $80,000	Over $54,000

For married individuals filing separate returns, the taxable income bracket amounts for 1987 are one-half the amounts for joint returns. The bracket amounts for surviving spouses are the same as those for married individuals filing joint returns.

Note: For 1987, the tax on long term capital gain income will not exceed 28%.[26] This cap on the capital gain tax is designed to prevent a disruption in economic activity during 1987, when the top marginal tax rate on ordinary income will exceed 28%. Taxpayers having long term capital gains during 1987 will pay tax at the lesser of the following amounts:

(a) a tax computed at regular tax rates on all taxable income including long-term capital gain income; or

(b) a tax computed at regular tax rates on ordinary income, *plus* 28% of all long-term capital gain income.

New Code §1(j) will also be applicable in any future tax year in which the top marginal tax rate on ordinary income exceeds 28%. Therefore, if Congress were to increase tax rates in the future, the 28% cap on long term capital gains income would be automatically triggered unless Congress also amended Code §1(j). If Code §1(j) applied in a tax year after 1987, the income tax computed above would be further adjusted to include the 5% surtax on taxable income within certain ranges. This surcharge is discussed, *infra,* under the heading, "3. Phase out of the 15% bracket.

2. Tax Rates—1988 and Later Years

The tax structure applicable in 1988 and later years consists of two brackets and tax rates: 15 and 28%.[27] A standard deduction replaces the pre-TRA law zero bracket amount (ZBA). The brackets are as follows:

Married Individuals Filing Jointly and Surviving Spouses

Tax Rate	*Bracket*
ZBA	Replaced by standard deduction
15%	$0 to $29,750
28%	over $29,750

For married individuals filing separate returns, the 15% bracket applies to taxable income not over $14,875 while the 28% bracket applies to taxable income above $14,875—one-half the taxable income amount for joint returns.

Heads of Household

Tax Rate	*Bracket*
ZBA	Replaced by standard deduction
15%	$0 to $23,900
28%	over $23,900

[23] *See* Act §101, revising Code §1(f).
[24] *See* Act §101(a), revising Code §1(f).
[25] Act §101(a), revising Code §1(h)(2).
[26] *See* Act §302(a)enacting new Code §1(j). See discussion of long term capital gains taxation at Chapter 2.
[27] Act §101(a), revising Code §1(a), (b), (c) and (d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Single Individuals

Tax Rate	*Bracket*
ZBA	Replaced by standard deduction
15%	$0 to $17,850
28%	over $17,850

Beginning in 1989, the range of income taxable at the 15% rate will be adjusted for inflation.[28] The method of computing the inflation adjustment is discussed, *infra,* under the heading, "4. Adjustment for Inflation."

3. Phase out of the 15% bracket

Beginning in 1988, the benefit of the 15% bracket is phased out for taxpayers having taxable income exceeding specified levels (the "applicable dollar amount"). The phase-out is accomplished by increasing the income tax liability of such taxpayers by 5% of their taxable income within the specified ranges. Therefore, for taxpayers within the specified ranges, the maximum tax rate applicable to a portion of the taxpayer's income will be 33% (5% in excess of the otherwise maximum rate of 28%).

This phase out is accomplished by a formula that first imposes a 5% surcharge on taxable income in excess of a specified amount, listed below, and then imposes a limit on the amount by which a taxpayer's tax may be increased by the 5% surcharge.[29] The limitation for the phase out of the tax benefit of the 15% bracket is 13% of the maximum amount of taxable income to which the 15% bracket applies. For 1988, the 15% bracket applies to taxable income of single taxpayers from zero to $17,850. Therefore the maximum amount of additional tax that will be imposed by the 5% surcharge is 13% of $17,850, or $2,320.50. Note that when this additional tax is coupled with the 15% tax applicable to income in this bracket, the taxpayer has paid a total of 28% on the income.

It takes $46,410 of income which, taxed at the 5% surcharge rate, will produce an additional tax of $2,320.50. Therefore, the effect of the phase out formula is to create a range of income in which the taxpayer's income is subject to a 33% tax. When the taxpayer's income exceeds the range, the marginal tax bracket applicable to the excess income is 28%.

For 1988, the phase out of the benefit of the 15% bracket begins at a dollar amount specified in the Code. This dollar amount threshold is listed below.[30] The limitation on the 5% surcharge has the effect of creating a range of taxable income within which the 5% surcharge is to apply. The range is shown in the following table beginning with the statutory threshold amount:

Filing Status	*Taxable Income Range*
Joint returns and surviving spouses	$71,900 and $149,250
Heads of households	$61,650 and $123,790
Single individuals	$43,150 and $89,560
Married individuals filing separately	$35,950 and $113,300

The amounts listed here will be adjusted for inflation beginning in 1989.[31] The method of computing the inflation adjustment is discussed, *infra,* under the heading, "4. Adjustment for Inflation."

In addition to phasing out the benefit of the 15% tax bracket, the Act phases out the benefit of the personal exemptions claimed by the taxpayer. The phase out of the personal exemptions begins at the point when the phase out of the benefit of the 15% bracket has been completed (*See* Chapter 10, I, *supra.*

Once the maximum rate adjustment has been reached, the taxpayer is again subject to the 28% tax bracket for income in excess of the adjustment range. In effect, these taxpayers will pay a flat tax of 28% on all of their taxable income.

4. Adjustment for Inflation

Beginning in 1989, both the tax rate brackets and the thresholds for determining to whom the 5% surcharge in tax rates apply are increased for inflation. In addition, inflation adjustments are made for the standard deduction and the personal exemption (*See,* Chapter 10, I, *supra*). The purpose of the adjustment is to prevent "bracket creep" in which a taxpayer's tax increases because of income increases that are made to keep the taxpayer abreast of inflation. A similar inflation adjustment applies to the tax brackets, zero bracket amount and personal exemptions applicable under pre-TRA law.

The inflation adjustment is made with reference to the Consumer Price Index (CPI) for all-urban customers published by the Department of Labor for the 12-month period ending on August 31 of each year. The amount of the adjustment to be made each year is the percentage, if any, by which the CPI for the current year exceeds the CPI for calendar year 1987. In the event the computation results in a number which is not a multiple of $50, the number is rounded to the next lowest $50. In the case of adjustments for married persons filing separate returns, the number is rounded to the next lowest $25, rather than the next lowest $50.[32] Note that if the CPI were to decline in any one year, a downward adjustment would be required by this formula. However, if the CPI declined below the 1987 level, no further downward adjustments would be made.

[28] *See* Act §101, revising Code §1(f).
[29] *See* Act §101(a), revising Code §1(g).
[30] *See* Act §101(a), revising Code §1(g)(3); H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-4 (1986) ("Conference Report").
[31] *See* Act §101(a), revising Code §1(g)(4).
[32] *See* Act §101(a), revising Code §1(f).

III. Income Averaging Repealed [Act §141]

Pre-TRA Code §§1301 through 1305 allow certain taxpayers to elect to pay a lower tax on income received in one year if it exceeds the income received in three prior years by a certain amount. The effect of these provisions is to provide some relief to taxpayers whose incomes fluctuate from year to year by taxing the income as if it had been received ratably over the averaging period. The amount of income which may be averaged is the portion of the current year's taxable income that is more than 40% higher than the average of the prior three years' taxable income.

Act §141 repeals income averaging for all taxpayers effective for taxable years beginning after December 31, 1986.[33]

Income averaging was a mechanism for reducing tax inequity for taxpayers whose income fluctuates from year to year. Lower marginal rates and the two bracket system (15 and 28%) results in fewer changes to a taxpayer's marginal rate, even with fluctuating income. The repeal of income averaging is not expected to create significant tax inequity for taxpayers. Perhaps more importantly, the repeal of income averaging is seen as means of reducing complexity in the tax system.[34]

IV. Special Rules for Unearned Income of Minors

A. Introduction

Under pre-TRA law, income earned on assets owned by a minor child generally was taxed to the child at the child's rate, and such tax was computed in the same manner as that of an adult. Congress was concerned that parents were transferring income-producing property to their children for income shifting purposes, so that the income would be taxed at the child's lower marginal rate. To augment the reforms aimed at reducing income shifting between family members, Congress focused on children under the age 14 and concluded that it would be appropriate to attribute a parent's top marginal rate to such child's unearned income.

B. Overview

The Act, §1411(a), enacted a new provision Code §1(i), commonly referred to as the "Kiddie Tax," which will tax a portion of the "net unearned income" of children under age 14 at their parents' top marginal tax rate.

C. Detailed Analysis

The 1986 TRA provision applies if the child has not attained age 14 before the close of the taxable year and if either parent of such child is alive at the close of the year.

Generally, under the Act, unearned income of a child under age 14 will be tax-free up to $500. A child's unearned income in excess of $500 up to $1,000 will be taxed at the child's marginal rate. The rest of the child's unearned income is taxed to the child at the parents' top marginal rate. A child's earned income will continue to be taxed at the child's marginal tax rate.

The "Kiddie Tax" is created by three Code sections: §1(i), as enacted by Act §1411(a), which sets forth the operation of the tax; §63(c), as amended by Act §102(a), which sets forth the definition of the standard deduction; and §151(d)(2), as amended by Act §103(a), which disallows a personal exemption deduction for certain minors.

Under 1986 TRA Code §63(c)(5), the standard deduction of a child under age 14 who is claimed as a dependent is limited to the greater of $500 or the child's earned income, but not to exceed the regular standard deduction. If itemized deductions are elected, the greater of $500 of all itemized deductions or the total of allowable deductions directly related to the production of unearned income may be applied against unearned income. The $500 figures will be adjusted for inflation beginning in 1988. In addition, §151(d)(2) disallows the personal exemption for such child if he is claimed as a dependent by his parents.

After these computations are made, under §1(i) the first $500 of unearned income of such child in excess of the greater of (a) the $500 standard deduction or $500 of itemized deductions or (b) the total of directly related itemized deductions is then taxed to the child at his own rates. In addition, all of the child's earned income is taxed to the child at his own rates. The remaining amount of the child's unearned income is defined as the child's "net unearned income" and it is that amount which is taxed to the child at his parents' tax rate.

Example: During 1988 a dependent child under age 14 has $5,000 of unearned income from a custodial account created by his grandmother. He also has $3,000 of earned income from his after school jobs. Under §63(c)(3), as limited by (c)(5), the child's standard deduction is $3,000 for taxable years beginning after 1987. The first $1,000 of unearned income will be taxed to the child at his marginal tax rate. He can apply $500 of his standard deduction against this amount, leaving $500 taxable at 15%. The remaining $4,000 will be taxable to the child at his parents' marginal tax rate. After applying $500 of his standard deduction against unearned income, the child has $2,500 of his standard deduction remaining which he applies to his earned income, leaving $500 of earned income taxable at 15%. Therefore, of his $8,000 of taxable income, $1,000 will be taxed at 15%, $4,000 will be taxed at his parents' marginal rate and $3,000 is sheltered by his standard deduction.

The child's net unearned income is then added to his parent's actual taxable income and the parent's tax is recomputed to find the "allocable parental tax." Code §1(i)(3) provides that the "allocable parental tax" equals the tax that the parent would have paid had the parent's taxable income actually included such unearned income less the tax actually imposed on the parent's taxable income. The unearned income of children is not taken into account in computing any deduction or credit of the parent. A child's share of any allocable parental tax of his parent is equal to an amount that bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the aggregate net unearned income of all children of such parent to whom these special rules apply.

[33] *See* Act §151(a).
[34] *See House Ways and Means Committee Report HR3838*, p. 114.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Example: Parents have three children, all under age 14. During 1988 each child has unearned income of $3,000. The parents have taxable income of $29,750. Of each child's unearned income, $1,000 is taxed at the child's marginal rate and $2,000 is taxed at the parents' rate. The parents' tax calculation is 15% of $29,750 or $4,462.50 plus 28% of $6,000 or $1,680. The additional tax of $1,680 will be split among the three children and each child will owe $560.

Under Code §1(i)(5), if the child's parents are not married, as determined under Code §7703, the custodial parent's income is used for purposes of computing the "Kiddie Tax." If the parents are married but filing separately, the higher income parent is used to compute the "Kiddie Tax." If the parents' taxable income is later adjusted to place them in a different tax bracket, presumably the child's tax will have to be recomputed.

The Treasury Department will issue regulations providing for the application of these provisions where either the child or the parent is subject to the alternate minimum tax for the year.[35]

Code §1(i) applies to all unearned income of a child under age 14, regardless of source. It thus applies to gifts made to the child from his parents, grandparents and friends. The new provision will be applicable to unearned income in trusts as well as custodial accounts created under the Uniform Gifts to Minors Act or Uniform Transfers to Minors Act. In addition, the provision applies to income earned on a child's earned income.

D. Effective Dates

Code §1(i) generally is effective for taxable years beginning after December 31, 1986. Therefore, the provision will apply to income from existing custodial accounts and income distributed from existing trusts, even though such custodial accounts and trusts were created before the effective date of the provision.

E. Planning Suggestions

This provision will discourage transfers from a parent to a child which are motivated solely for income shifting purposes, if the child is under age 14. However, income shifting may be less important due to the lowering of the individual rate schedules. Nevertheless, in future planning, consideration should be given to creating sprinkle spray discretionary trusts for children so that the trustee may control the amount and timing of income distributed to children under age 14. Note, however that undistributed trust income will be subject to the compressed tax bracket rates under the new trusts and estates provisions.

Consideration should also be given to changing investments of existing trusts and custodial accounts to growth oriented securities, tax-exempt municipal or state bonds, or Series EE bonds until the child reaches age 14. Zero coupon bonds should be avoided because the accrued income on such bonds is taxable currently even though not received.

It may be advantageous for a child under 14 to receive up to $1,000 of unearned income, of which $500 will be tax-free and the second $500 will be taxed at the child's marginal rate.

Transfers to minors remain advantageous for general estate planning purposes. A parent may wish to utilize his annual gift tax exclusion and unified credit to transfer property to his minor children, regardless of the income tax consequences. Since the highest estate marginal tax rate is 55% until 1988, when it becomes 50%, it still is advantageous in many estates to transfer property to children in order to avoid the estate tax on subsequent appreciation.

Practical problems involving the "Kiddie Tax" may be encountered. Since the child's return will be based upon his parent's computations, there may be tensions created if the parents are divorced. Moreover, subsequent adjustments in the parent's return will require adjustments in the child's return.

V. Filing Requirements [Act §104]

The Act changed the rules for determining when a return is required to be filed by a taxpayer. The changes were made to conform the filing requirements to the changes made to the standard deduction and personal exemptions. Under the Act, a taxpayer is required to file an income tax return if his gross income exceeds the sum of the personal and dependent exemptions plus the basic standard deduction available to the taxpayer.[36]

A single taxpayer, a head of a household, or a surviving spouse must file a return if gross income exceeds one personal exemption plus the applicable standard deduction.[37]

Married taxpayers who are eligible to file a joint return must file a return if their combined incomes exceed two personal exemptions plus the standard deduction available to joint returns. However, this higher threshold is only available to married taxpayers who had the same household as their home at the end of the taxable year.[38]

If a married couple elects to file separate returns, and neither spouse itemizes deductions, then each spouse must file a return if his or her income exceeds one personal exemption plus the standard deduction available to married persons who are filing separately. If either spouse itemizes deductions, then each spouse who has income in excess of the personal and dependent exemptions available to him or her must file a return.

For the purposes of determining whether a return is required to be filed, the standard deduction of an unmarried, elderly taxpayer includes the additional standard deduction available to him or her by reason of his or her age ($750 in 1987 and 1988, adjusted for inflation thereafter). For married, elderly taxpayers (whether or not they file a joint return), the standard deduction used to determine whether a return is required to be filed includes the one or

[35] Conference Report, p. II-767-68.

[36] *See* Act §104(a), revising Code §6012.
[37] *See* Act §104(a), revising Code §6012(a)(1)(A)(i), (ii) and (iii).
[38] *See* Act §104(a), revising Code §6012(a)(1)(A)(iv).

two additional standard deductions available to them by reason of their ages ($600 in 1987 and 1988, adjusted for inflation thereafter). However, the filing requirement applicable to blind taxpayers is not adjusted for the additional standard deduction available to them by reason on their blindness.[39]

For a dependent child under age 14 who is subject to a lower standard deduction under Code §63(c)(5), the lower amount is used to determine if a return is required to be filed by the child.[40]

Certain taxpayers are not eligible for any standard deduction under Code §63(c)(6). These taxpayers include married taxpayers filing separate returns where either one itemizes deductions, nonresident alien taxpayers, taxpayers filing a short-year return in order to change an annual accounting period, estates, trusts, common trust funds and partnerships. These taxpayers are required to file a return if gross income exceeds the personal and dependent exemptions available to the taxpayer for the year.[41]

The amendments made to Code §6012 by Act §104(a) are effective for taxable years beginning after December 31, 1986.[42]

[39] *See* Act §104(a), revising Code §6012(a)(1)(B).
[40] *See* Act §104(a), revising Code §6012(a)(1)(C).
[41] *See* Act §104(a), revising Code §6012(a)(1)(C).
[42] *See* Act §151(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 11

AMENDMENTS AFFECTING THE INVESTMENT, ENERGY, AND REHABILITATION CREDITS

Patrick G. Dooher, Esq.
Silverstein and Mullens
Washington, D.C.

I. Background

Code §46 provides for the allowance of an investment credit of up to 10% of the basis or cost of "§38 property" placed in service by the taxpayer during the taxable year. Section 48(a) sets forth the categories of property eligible for the credit, the most notable of which is tangible personal property.

An additional 10 to 15% credit is available to taxpayers for investments in certain types of energy property.[1] Energy property for which the energy credit was available through 1985 included ocean thermal property, solar, wind, or geothermal property, and qualified hydroelectric generating property.[2]

For expenditures incurred to rehabilitate certain buildings, an increased investment credit may be claimed in lieu of of the regular and energy investment credits. This rehabilitation credit is equal to 15% of the qualified rehabilitation expenditures (QRE) for a 30-year old building, 20% of such expenditures for a 40-year old building, and 25% of such expenditures for a certified historic structure.[3]

Section 48(g) sets forth the requirements that must be satisfied to obtain the rehabilitation credit. Under §48(g)(1)(A), a qualified rehabilitated building is a building (i) that has been "substantially rehabilitated," (ii) that was placed in service before the beginning of the rehabilitation, and (iii) that has retained 75% or more of the existing external walls as external walls in the rehabilitation process. Under §48(g)(1)(C), a building has been "substantially rehabilitated," if the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer exceed the greater of (i) the adjusted basis of the building (and its structural components), or (ii) $5,000. Any expenditure by a lessee will not be considered a qualified rehabilitation credit expenditure if on the date the rehabilitation is completed, the remaining term of the lease (determined without regard to any renewal periods), is less than 19 years (15 years in the case of low-income housing).[4] An expenditure is a qualified rehabilitation expenditure, if, among other things, it is incurred for property (or additions or improvements to property) having a recovery period within the meaning of §168 of 19 years, and is incurred in connection with the rehabilitation of a qualified rehabilitated building; a rehabilitation expenditure does not qualify unless the straight-line cost recovery method under §168(b)(3) is elected with respect to the expenditure.[5]

Under §48(g)(1)(E), the 75% external wall test of §48(g)(1)(A)(iii) is deemed satisfied if, in the rehabilitation process, the following three requirements are met:

> (i) at least 50% of the building's external walls are retained in place as external walls;
>
> (ii) at least 75% of the building's external walls are retained in place as either external walls or internal walls; and
>
> (iii) at least 75% of the building's internal structural framework is retained in place.

Section 48(d) grants an election to the lessor of new §38 property to pass through the investment credit to the lessee instead of using the credit itself.

Code §47 requires the recapture of investment credits on property disposed of or ceasing to be §38 property prior to the end of certain designated periods.

If the regular investment credit, the 10 to 15% energy investment credit, or the 25% rehabilitation credit for certified historic structures is claimed, the basis of the property qualifying for the credit is reduced by 50% of the amount of the credit claimed under §48(q). If the 15% or 20% rehabilitation credit is claimed, the basis of the rehabilitated property must be reduced by the full amount of the credit.[6] The lower basis is used to compute cost recovery (or depreciation) deductions and capital gain or loss. In lieu of the 50% basis reduction where the regular credit is claimed, a taxpayer may elect to claim a reduced regular credit.[7]

II. Overview

The 1986 TRA[8] generally repeals the regular investment credit of up to 10% for property placed in service

[1] §46(b)(2)(A).
[2] *Id.*
[3] §46(b)(4)(A).
[4] §§48(g)(1)(C)(iii) and (2)(B)(v) before amendment by the 1986 TRA.
[5] §48(g)(2).
[6] §48(q)(3).
[7] §48(q)(4) provides a reduced credit of 4% for 3-year property and 8% for all other property.
[8] Act §211.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

after December 31, 1985. Extensive transition rules are provided. However, the credit on property qualifying under the transition rules, as well as credit carryforwards, may be subject to reduction.

The 1986 TRA [9] extends the energy investment credit for certain types of energy property for up to a three-year period.

Finally, the 1986 TRA [10] also restricts the rehabilitation credit, effective generally for property placed in service after 1986. Transition rules are provided under which property placed in service after 1986 may qualify for the more liberal pre-1987 rehabilitation credit. However, the credit on property qualifying for such transition relief may be reduced.

III. Analysis of Credit Changes

A. Termination of Regular Investment Credit

1. General

Code §49(a), as added by the 1986 TRA ("Act"),[11] provides that the 10% regular investment credit (which is effectively reduced to 6% for 3-year property by §46(c)(7)) will not apply to property placed in service after December 31, 1985. Section 49(b) provides three exceptions to the foregoing rule. First, the regular credit will be available for property that is "transition property" (including qualified progress expenditures on property that will constitute "transition property" when placed in service). Second, the regular credit will be available for qualified progress expenditures incurred before January 1, 1986, regardless of whether the property constitutes "transition property." Finally, the regular credit will remain available for qualified reforestation expenditures described in §48(a)(1)(F).

2. Transition Property

a. General

"Transition property" is defined in §49(e). In general, the definition relies on the transition rules provided under the revised Accelerated Cost Recovery System (ACRS) inAct §§203 and 204, but substituting an earlier effective date for the effective date used for ACRS purposes. In order to satisfy the general transition rules of the ACRS, property both must fall into a specific effective date category and must be placed in service by a specified date in the future depending upon its ADR class life. Both the category requirement and placement in service requirement are described below.

b. Category Requirement

As modified for purposes of the §49 termination provisions, property may qualify as transition property if it falls into one of the following effective date categories:

(a) Any property constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract that was binding on December 31, 1985;

(b) Property that is constructed or reconstructed by the taxpayer, if (a) the lesser or $1 million or 5% of the cost of such property has been incurred or committed by December 31, 1985, and (b) the construction or reconstruction of the property began by the December 31st date;

(c) An equipped building or plant facility if (a) construction commenced as of December 31, 1985, pursuant to a written specific plan, and (b) more than one-half of the cost of the equipped building or facility was incurred or committed by the December 31st date; or

(d) Property readily identifiable with and necessary to carry out a written supply or service contract, or agreement to lease, that was binding on December 31, 1985.

(1) Binding Contracts

The Conference Report [12] elaborates at length upon the binding contract rule. The Report provides that, if a taxpayer transfers his rights in any property subject to the binding contract that is under construction or transfers his rights in the contract to another taxpayer, the revised ACRS will not apply to the property in the hands of the transferee taxpayer provided the property was not placed in service by the transferor before the transfer period.[13] Moreover, if a partnership terminates under §708(b)(1)(B) by reason of sales or exchanges of partnership interests, the partnership is to be treated as having transferred its rights in the transition rule property to the new partnership.

The Conference Report further states that the binding contract rule applies only to contracts in which the construction, reconstruction, or acquisition of property is itself the contract subject matter.[14] Moreover, a contract is to be considered binding only if it is enforceable under state law and does not limit damages to a specified amount, such as in a liquidated damages provision. A contract limiting damages to an amount equal to at least 5% of the total contract price, however, will not be treated as limiting damages. A contract granting the taxpayer an option to acquire property is not to be treated as a binding contract to acquire the property, but a contract under which the taxpayer grants an irrevocable put (an option to sell) to another taxpayer is considered a binding contract since the grantor of the put option does not have the ability to rescind unilaterally the commitment to sell. A contract subject to a condition not within the control or either party or a predecessor (except in limited circumstances described below) is considered binding. A contract binding as of December 31, 1985, will not be considered binding at all times thereafter if it is substantially modified after that date. However, design changes to a binding construction contract that are made for reasons of technical or economic efficiencies of operation and that cause an insignificant increase in the original contract price will not constitute substantial modification of the contract. Additionally, a supplementary

[9] Act §421.
[10] Act §251.
[11] Act §211(a).

[12] H.R. Rep. No. 841, 99th Cong., 2d Sess II-54-56 (1986) ("Conf. Rep.").
[13] In what appears to be typographical error, the Conference Report refers to placement in service by the transferee, rather than the transferor.
[14] Conf. Rep. at II-55.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

contract that stands on its own and does not govern by the binding contract rule will not adversely affect the status of the portion of the property subject to the binding contract transition rule.

The Report [15] further states that a binding contract to acquire a component of a larger property will not be treated as a binding contract to acquire the larger property for purposes of the transition rule. For example, a binding written contract entered into before January 1, 1986, to acquire an aircraft engine would not be treated as a binding contract that relates to the entire aircraft.

(2) Self-Construction

The Conference Agreement provides that a taxpayer is allowed transition relief for property under construction or reconstruction by the taxpayer, if (i) the lesser of $1 million or 5% of the property's cost was incurred or committed pursuant to a binding written contract in effect as of December 31, 1985, and (ii) the construction or reconstruction began by that date. For purposes of this transitional rule, the construction of property is considered to begin when physical work of a significant nature starts. Construction has not begun if work has started on only minor parts or components. Moreover, physical work does not include preliminary activities such as planning or designing, financing, exploring, researching, or developing.[16]

For purposes of the self-constructed property transition rule, a building is to be treated as including all the normal and customary components that are purchased from others and installed without significant modification, such as light fixtures.[17]

(3) Equipped Buildings and Plant Facilities

An equipped building or plant facility may qualify for transition relief if construction began on or before December 31, 1985, pursuant to a written plan, and more than 50% of the building or facility cost was incurred or committed by December 31, 1985.

The Conference Report [18] provides that if an equipped building fails the more than 50% adjusted basis test, each item of machinery and equipment to be installed in the building is treated separately for purposes of determining whether that item qualifies for transition relief. If, however, the more than 50% test is satisfied, "incidental appurtenances," as well as equipment and machinery installed in the building, qualifies under the equipped building category. The Report describes incidental appurtenances as appurtenances that are incidental to the operations carried on in the building but that are not themselves located in the building. For example, an adjacent railroad siding dynamo, or water tower used in connection with a manufacturing process, or other incidental structures or machinery and equipment necessary to the planned use of the building, may qualify as incidental appurtenances. However, appurtenances do not include a plant needed to supply materials to be processed or used in the building under construction. Significantly, the Conference Report makes it clear that the incidental appurtenances which will be subject to the transition rule are not to be counted in determining whether the equipped building satisfies the more than 50% test.

The written plan for the equipped building must be, according to the Conference Report,[19] a definite, specific, written plan of the taxpayer that is available as evidence of the taxpayer's intentions. The written plan may be modified, but only to a minor extent, after December 31, 1985. If substantial modifications in the plan are made, the equipped building transition rule will not apply.

The plant facility rule is designed to be comparable to the equipped building rule and to apply to facilities not housed in a building.[20] The transition rules [21] define a "plant facility" as a facility not including any building (or with respect to which buildings are an insignificant portion) and which is (i) a self-contained single operating unit or processing operation, (ii) located on a single site, and (iii) identified as a single unitary project as of December 31, 1985.

The Conference Report states that construction of a plant facility, which is required to have begun by December 31, 1985 in order to qualify under the rule, is not considered to have begun until it has commenced at the site of the plant facility. This rule does not apply if the facility is not to be located on land and, consequently, the initial work on the facility must begin elsewhere. Construction of the plant facility is deemed to begin only when actual work at the site commences. For example, when work begins on the excavation for footings, or the pouring the pads for the facility, or the driving of foundation pilings into the ground, then construction is deemed to begin. Preliminary work, such as clearing, test drilling, or excavation to change a land contour is not treated as the commencement of construction.[22]

(4) Supply and Service Contracts; Leases

Another transition rule of general effect provides that the revised ACRS (and consequently the investment credit) will not apply to any property that is "readily identifiable with and necessary to carry out a written supply or service contract, or agreement to lease," that was binding on December 31, 1985.[23] The Conference Report [24] explains that this transition rule is provided for those situations where a pre-January 1, 1986, written binding contract requires the construction or acquisition of property but the contract is not between the person who will own the property and the person who will construct or supply the property. The Report further states that the rule applies only where the specifications and amount of the property are readily ascertainable from the contract terms or related documents. A supply or service contract or lease agreement must satisfy the various, previously-described requirements for a binding contract, such as that no substantial modifications are being made to the contract after December 31, 1985. A change in the method or amount of compensation

[15] *Id.*
[16] Conf. Rep. at II-56.
[17] *Id.*
[18] Conf. Rep. at II-56 and 57.
[19] *Id.*
[20] Con. Rep. at II-57.
[21] Act §203(b)(4).
[22] Conf. Rep. at II-58.
[23] Act §204(a)(3).
[24] Conf. Rep. at II-59 and 60.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

for services under the contract will not be considered a substantial modification if, taken as a whole, the change does not affect the scope or function of the project. If additional property is included under a supply or services contract or lease agreement after December 31, 1985, the transition rule will not apply to the additional property.

The Conference Report [25] gives as an example of a lease agreement to which the transition rule could apply a finance lease (to the extent the transition rules continues to permit finance leases) under which a grantor trust is obligated to provide property. The Report also clarifies that the transition relief will apply to cable television franchise agreements embodied in whole or in part in municipal ordinances or similar enactments before January 1, 1986.

c. Placement in Service Requirement

The foregoing transition relief will not be available unless an additional placement in service requirements is satisfied.[26] To meet this requirement, property qualifying under a specific category must be placed in service by an applicable date based upon the property's ADR class life. For property whose class life is less than five years, such as a car or light-duty truck, the property must have been placed in service before July 1, 1986. For property whose class life exceeds five years but is less than seven years, such as a computer or photocopy equipment, the property must have been placed in service before January 1, 1987. For property with a class life of at least seven years but less than 20 years, the property must be placed in service before January 1, 1989. For example, a bus, which has a 9-year ADR class life [27] or a tugboat, which has an 18-year ADR class life,[28] which was under a binding purchase contract on or before December 31, 1985, must be placed in service by December 31, 1988, to qualify. Finally, for property whose class life is at least 20 years, the property must be placed in service before January 1, 1991. Thus, an item such as a billboard, which has a 20-year ADR class life,[29] must be placed in service by December 31, 1990. Finally, the applicable date for residential rental property and nonresidential real property is January 1, 1991. Thus, for example, the regular credit may remain available through 1990 for elevators installed in a new office or commercial building under contract or construction by December 31, 1985.

Property with no class life is treated as having a class life of 12 years.[30] Moreover, any property to be provided under a supply or services contract or lease agreement is treated as having a class life of 20 years.[31]

The ADR class life to be used in determining the property's qualification under the transition rule and its applicable placement in service date is, with one exception, the ADR class life prescribed in Rev. Proc. 83-35. The sole exception is that computer-based telephone central office switching equipment described in revised §168(e)(3)(E)(iii) is treated as having 6-year ADR class life. Thus, such equipment does not qualify for transition rule relief for purposes of the revised ACRS.

Note: The modifications made to the class lives of certain property for purposes of the alternative depreciation system in revised §168(g)(3)(B) do not apply for transition rule purposes. The transition rules [32] state that it is the class life of such property on January 1, 1986, that must be used.

The Conference Report [33] provides that taxpayers who have difficulty identifying what property is placed in service under their accounting system because they regularly enter into contracts for large stocks of identical or similar items of property to be placed in service as needed. Such taxpayers may assume that the first items placed in service after December 31, 1985 are those under a binding pre-January 1, 1986 contract. A similar rule is to apply to self-constructed property.

The Report [34] further states that property incorporated into an equipped building or plant facility need not independently satisfy the placed-in-service requirement. Such incorporated property qualifies for transition relief as part of the equipped building or plant facility provided the building or facility is placed in service by the prescribed placement in service date.

d. Sales and Leasebacks; Section 48(d) Election

Transition rules [35] provide that, if a taxpayer acquires property from a person either in whose hands such property met one of the transition rules or who placed the property in service before 1986, and if the taxpayer leases back the property to that person not later than the earlier of (i) the applicable placement in service date or (ii) the day that is 3 months after the property was placed in service, the property will be deemed to continue to qualify under the transition rule in the taxpayer's hands.

The Conference Report [36] provides that the rule will apply where the taxpayer acquires property from a manufacturer, places the property in service by leasing it to the ultimate user, and subsequently engages in a sale-leaseback within 3 months after the property was originally placed in service under the initial lease. The Report further states that, if the facility otherwise qualifies as an equipped building and if a portion of the facility is sold and leased back in accordance with the sale and the leaseback requirements, both the leased and retained portion will continue to qualify under the equipped building transition rule.

The Conference Report [37] states that a taxpayer in whose hands property qualifies for transition relief can elect under §48(d) to pass the credit claimed to a lessee of the property.

3. Credit Reduction

Section 49(c) requires a 35% reduction in the amount of the regular investment credit claimed on any transition property placed in service in a taxable year beginning after

[25] *Id.*
[26] Act §203(a)(2)
[27] *See* Rev. Proc. 83-35, 1983-1 C.B. 745, Asset Guideline Class 00.23.
[28] *Id.*, Asset Guideline Class 00.28.
[29] *Id.*, Asset Guideline Class 57.1.
[30] Act §203(b)(2)(C)(iii).
[31] Act §203(b)(2)(C)(ii).
[32] Act §203(B)(2)(C)(i).
[33] Conf. Rep. at II-53 and 54.
[34] Conf. Rep. at II-54.
[35] Act §203(b)(3).
[36] Conf. Rep. at II-53.
[37] *Id.*, at II-64.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

June 30, 1987. Moreover, a lesser reduction in the regular credit is required for any property placed in service during a taxable year that straddles July 1, 1987. §49(c)(3). The straddle-year reduction is computed by multiplying 35% by the ratio of the number of months in the straddle year after June 30, 1987, to the total number of months in the straddle year. §49(c)(5). For a 1987 calendar year taxpayer, assuming a 12-month taxable year, a 17.5% cutback would be required since one-half the number of months in the calendar year falls after June 30, 1987.

Assuming a 12-month taxable year, the percentage reductions that are required for taxable years beginning August 1, 1986, through June 1, 1987, are as follows:

Month Year Begins	Percentage Reduction
August 1, 1986	2.9167%
September 1, 1986	5.8333%
October 1, 1986	8.7500%
November 1, 1986	11.6667%
December 1, 1986	14.5833%
January 1, 1987	17.5000%
February 1, 1987	20.4167%
March 1, 1987	23.3333%
April 1, 1987	26.2500%
May 1, 1987	29.1667%
June 1, 1987	32.0833%

These same rules also apply to any business credit carryforward attributable to the regular investment credit after June 30, 1987. §49(c)(3)(B).

For purposes of determining the amount of a credit carryforward from a taxable year straddling July 1, 1987, the credit carryforward is increased by the amount of any straddle-year reduction. This rule is designed to prevent a double reduction, one for the straddle year and a second for the first post-straddle year, in the amount of the credit carried to the first post-straddle year.

Observation: In determining what portion of a credit carryforward is attributable to the regular investment credit, §49(c)(5)(C) provides that the regular credit is deemed to be absorbed first in any taxable year. This is a favorable rule because if a taxpayer has regular and rehabilitation credits arising in a pre-1987 taxable year which contribute to a post-1986 credit carryforward, only the portion of the carryforward allocable to the regular credit is subject to the reduction, and it is this portion to which pre-1987 taxes are applied first. The rule thereby maximizes the portion of the carryforward considered attributable to the rehabilitation credit, which is not subject to the reduction.

Example: Assume that in 1985 the regular credit amounted to $50,000, the rehabilitation credit amounted to $50,000, and the combined $100,000 of credits offset $60,000 in taxes. For purposes of determining the credit carryover, the entire $50,000 of regular credit and only $10,000 of rehabilitation credit are treated as offsetting the $60,000 of taxes. Consequently, the $40,000 of unused credit, which becomes a credit carryover, is entirely attributable to the rehabilitation credit. Assuming the $40,000 carryover survives into 1987, it will not be subject to the applicable reduction required in 1987 for a regular credit carryover.

4. Full Basis Reduction

For transition property, a basis reduction equal to the full amount of the credit claimed must be made in lieu of the 50% basis reduction that obtains under pre-1986 TRA §48(q).[38] Moreover, the election to claim a reduced credit, in lieu of a basis reduction, is precluded by §49(d)(1)(B). However, if a taxpayer elected the reduced credit for qualified progress expenditures attributable to periods before January 1, 1986, no basis reduction is required with respect to such pre-1986 expenditures, and the election terminates with respect to post-1985 expenditures.[39]

4. Steel Company and Farmer Carryback

Under the 1986 TRA,[40] steel companies and farmers may effectively elect up to a 15-year carryback period in lieu of carrying forward unused regular credits to a taxable year beginning after 1986. The maximum amount to which the election can be applied is the lesser of (i) 50% of the portion of the taxpayer's existing carryforwards to which the election applies, or (ii) the taxpayer's net tax liability for the carryback period. Act §§212(b) and 213(b)(1) and (2). Moreover, farmers, but not steel companies, are limited to a maximum of $750. Act §213(b)(3). Thus, the maximum amount of credit carryforward for which a farmer can elect the extended carryback period is $1,500.

The carryback period as to which the election will apply is the period that begins with the corporation's or farmer's 15th taxable year preceding the first taxable year from which there is an unused credit included in the corporation's or farmer's existing carryforwards and that ends with the corporation's or farmer's last taxable year beginning before January 1, 1986.[41] However, in no event may the carryback period begin before the corporation's or farmer's first taxable year ending after December 31, 1961.[42]

Note: The add-on minimum tax of §56 (until its repeal by the 1986 TRA) may apply to the tax preference items of corporations to the extent the preference items exceed the greater of $10,000 or the regular tax deduction. The regular tax deduction is defined by §56(c) as the amount of tax (but excluding certain taxes) imposed on the corporation for the year reduced by nonrefundable credits, including the investment credit. As a result of the carryback election of a post-1986 regular credit carryforward, a tax that may have applied to cut minimum tax liability in a prior year may be reduced. The carryback rules specifically provide that the minimum tax of §56 need not be recomputed in such event to reflect any reduction in the regular tax arising from the carryback election.[43] A similar rule applies to any add-on minimum tax that may have been imposed on a noncorporate farmer for a year beginning before January 1,

[38] §49(d).
[39] §49(d)(2).
[40] Act §§212 and 213.
[41] Act §§212(d)(3) and 213(b).
[42] *Id.*
[43] Act §212(e).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

1982, when noncorporate taxpayers were also subject to the §56 minimum tax.[44]

B. Energy Investment Credit

1. Extension of Credit for Certain Property

The 1986 TRA[45] extends the energy investment credit for certain types of energy property.

Under new §46(b)(2)(A)(viii), the credit for solar energy property is 15% for the period January 1, 1986, through December 31, 1986, 12% for the period January 1, 1987, through December 31, 1987, and 10% for the period January 1, 1988, through December 31, 1988.

For geothermal property, a 15% credit is provided for the period January 1, 1986, through December 31, 1986, and a 10% credit is provided for the period beginning January 1, 1987, through December 31, 1988. §46(b)(2)(A)(ix).

For ocean thermal property, a 15% credit is provided for the period beginning January 1, 1986, and ending December 31, 1988. §46(b)(2)(A)(x).

Finally, for biomass property, a 15% credit is available from January 1, 1986, through December 31, 1986, and a 10% credit is available from January 1, 1987, through December 31, 1987. §46(b)(2)(A)(xi).

2. Cutback and Basis Reduction for Certain Energy Property

For energy property placed in service in a taxable year beginning after June 30, 1987, pursuant to §46(b)(2)(C) or (D), which provides extended grace period for placing in service certain types of energy property, a 35% reduction in the energy credit amount is required. If such property is placed in service in a taxable year straddling July 1, 1987, the straddle-year reduction described above in connection with the regular investment credit is required. These reductions will also apply to any portion of a credit carryforward to post-1986 years attributable to an energy credit allowed under §46(b)(2)(C) or (D). Moreover, a basis reduction equal to the full amount of such a credit claimed after 1985 must be made. Act §421(b).

The amendments made to these provisions by the 1986 TRA apply to periods beginning after December 31, 1985, under rules similar to rules under revised §48(m). Act §421(c).

C. Rehabilitation Credit

1. Reduced Percentages

The 1986 TRA[46] amends §46(b)(4) to replace the three-tier rehabilitation credit with a two-tier credit. The 15 and 20% credits for 30-year old and 40-year old buildings, respectively, are superseded by a 10% credit that will be available only for a building that was first placed in service before 1936. The 25% credit available for the rehabilitation of certified historic structures is replaced by a 20% credit.

2. Revised §48(g) Requirements

a. General

The 1986 TRA[47] revises §48(g). The three principal changes made in the revision are:

(i) For nonhistoric rehabilitations, to substitute the "alternative wall" test of former §48(g)(1)(E) for the 75% external wall requirement and, for certified historic rehabilitations, to eliminate completely any external wall test;

(ii) For nonhistoric rehabilitations, to require that the building have been first placed in service before 1936, and

(iii) For all rehabilitations, to conform the definition of a qualified rehabilitation expenditure to the revised Accelerated Costs Recovery System of §168, as amended by the 1986 TRA.

b. Qualified Rehabilitated Building; Substantial Rehabilitation

Revised §48(g)(1)(A) continues the requirements that a building must be "substantially rehabilitated" and must have been placed in service before the beginning of the rehabilitation in order to constitute a "qualified rehabilitated building" for rehabilitation credit purposes. Revised §48(g)(1)(C) also retains the pre-1986 TRA definition of "substantially rehabilitated." Under this definition, a building is treated as "substantially rehabilitated" only if the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer and ending with or within the taxable year exceed the greater of $5,000 or the adjusted basis of the building (and its structural components).[48]

c. External, Internal Wall Test

The former "alternative wall" test, which becomes the sole test relating to the retention of walls for purposes of revised §48(g), calls for the satisfaction of three requirements:

(i) At least 50% of the existing external walls of the building must be retained in place as external walls,

(ii) At least 75% of the existing external walls of the building must be retained in place as internal or external walls, and

(iii) At least 75% of the existing internal structural framework of the building must be retained in place.

Comment: The "alternative wall" test was enacted by the Tax Reform Act of 1984[49] and was viewed as a liberalizing modification of the law. According to the Senate Finance Committee Report accompanying the 1984 Act,[50] the alternative test was enacted to facilitate the qualification for the rehabilitation credit by buildings that

[44] Act §213(d).
[45] Act §421.
[46] Act §251(a).
[47] Act §251(b), amending §48(g).
[48] Section 48(g)(1)(C) further permits the substitution of a 60-month period for the 24-month period for phased rehabilitations completed pursuant to architectural plans and specifications, as under pre-1986 TRA law.
[49] P.L. 98-369, Act §1043(a), adding §48(g)(1)(E).
[50] S. Rep. No. 169, 98th Cong., 2d Sess. p. 822 (1984).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

were not square or rectangular in shape. Obviously, since the test was simply an "alternative" test (as the 75% test remained available for rehabilitation credit purposes), the alternative wall test could assist in qualifying a building for the credit that otherwise might not qualify. However, the substitution of this test as the sole test will significantly restrict a taxpayer's flexibility to modify a noncertified historic structure's internal structural framework in a rehabilitation. Initially, this becomes apparent from the 1984 Act Senate Finance Committee Report,[51] which states that all load-bearing internal walls and any other internal structural supports present in the building before rehabilitation begins, including columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building, must be treated as part of the building's internal structural framework for purposes of the alternative wall test. Thus, at least 75% of these items must be retained to qualify for the 10% credit under revised §48(g). Moreover, the Senate Finance Committee Report to the 1986 TRA [52] confirms that this test is intended to be more restrictive. It states that a building that is completely gutted will no longer qualify for the credit and then reiterates the same language from the 1984 Committee Report concerning the items that constitute a building's internal structural framework.

Revised §48(g) completely deletes the external wall requirement for certified historic structures. The Senate Finance Committee Report [53] states the Committee's belief that the Standards for Rehabilitation of the Secretary of the Interior ensure that certified historic structures are properly rehabilitated and that, therefore, the external wall requirement for such buildings was deleted to provide the Interior Secretary with "appropriate flexibility." The Report adds, however, that the 20% credit for certified historic structures should continue to be allowed only for true rehabilitations and not for substantially new construction and that the Interior Secretary is expected to continue generally to deny certification to rehabilitations in which less than 75% of the external walls will not be retained in place.

d. Pre-1936 Requirement

Another change, which is also a limiting change for noncertified historic structures, is the §48(g)(1)(B) requirement that the building must have been first placed in service before 1936. With the passage of time, fewer pre-1936 buildings will be worth rehabilitating from an economic standpoint, particularly in view of the more stringent retained wall requirement that will preclude gutting a building. Consequently, it is likely that the 10% credit for noncertified historic structures will eventually cease to be a viable rehabilitation incentive.

e. Qualified Rehabilitation Expenditure

Section 48(g)(2) restates the definition of a "qualified rehabilitation expenditure as follows. It is an expenditure that is properly chargeable to capital account for property for which depreciation is allowable under §168 and which is (i) nonresidential real property, (ii) residential rental property, (iii) real property that has a class-life of more than 12.5 years, or (iv) an addition or improvement to property or housing described in (i), (ii), (iii). Finally, the expenditure must be incurred in connection with the rehabilitation of a qualified rehabilitated building.

Revised §48(g)(2) refers to §168 and the revised ACRS for the definitions of "nonresidential real property," "residential rental property," and "class life." Under the revised ACRS, nonresidential real property is §1250 property that is not residential rental property or property with a class-life of less than 27.5 years.[54] Nonresidential real property is depreciated over 31.5-year recovery period.[55] Residential rental property is a building or structure where at least 80% of the gross rental income from the building or structure for the year is rental income from dwelling units but not including rental units used on a transient basis such as hotel or motel units.[56] Residential rental property is depreciated over 27.5 years on a straight-line basis under the revised ACRS.[57]

Note: The 1986 TRA does not amend the limitation of §48(a)(3) that property used for lodging, except on a transient basis, generally does not qualify for a credit with an exception provided for the rehabilitation of certified historic structures. Thus, residential rental property will continue not to qualify for a credit under §48(a)(3) unless the residential rental property being rehabilitated is a certified historic structure.

The final category of property that may qualify is real property having a class-life of more than 12.5 years. Revised §168(i)(1) provides that "class life" means the class life, if any, that would apply to property as of January 1, 1986, under the Asset Depreciation Range (ADR) system of §167(m). The class lives of property may generally be found in Rev. Proc. 83-35 [58] but these class lives will be subject to modification in accordance with §168(i)(1).[59] Under Rev. Proc. 83-35, farm buildings, which have a class life of 25 years, may qualify for the rehabilitation credit as may service stations and car wash buildings, which have 20-year class lives.[60]

Note: Land improvements such as sidewalks, roads, and landscaping have a 20-year class-life [61] and, thus, arguably qualify for the credit if made "in connection with" the rehabilitation of a qualified building. However, the proposed regulations under existing §48(g) [62] take the position that expenditures attributable to work done to facilities related to a building such as sidewalks, parking lots, and landscaping, are not considered made in connection with a qualified building rehabilitation.

[51] *Id.*
[52] S. Rep. No. 313, 99th Cong., 2d Sess. p. 754 (1986).
[53] *Id.*, at 754-755.
[54] Revised §168(e)(2)(B).
[55] Revised §168(c).
[56] Revised §168(e)(2)(A).
[57] §168(c) and (b).
[58] 1983-1 C.B. 745.
[59] Also, for purposes of the alternative depreciation system of §168(g), the class life of certain categories of property are modified. These modifications would appear to apply only for purposes of the alternative depreciation system; *see* §§168(g)(2) and 168(g)(3)(B).
[60] *Id.*, Asset Guideline Class 01.3 for farm buildings and 57.1 for service station and car wash buildings.
[61] *Id.*, Asset Guideline Class 00.3 for land improvements.
[62] Prop. Regs. §1.48-12(c)(5).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Observation: A special rule in the pre-1986 TRA ACRS [63] effectively provides that a building and structural components will not be treated as 10-year property if the building is converted to a theme or amusement park structure after it was originally placed in service. The effect of this rule is to clarify that the building will be treated as 19-year real property eligible for the rehabilitation investment credit. This special rule is not retained in the revised ACRS. Moreover, the rehabilitation credit provisions [64] specifically provides that real property having a class life of more than 12.5 years may qualify for a rehabilitation credit,[65] in addition to specifying that nonresidential real property and residential rental property may qualify for the credit.[66] The legislative history is silent as to whether the omission of the special rule from revised §168 and the specification of a more than 12.5 year ADR class life for real property in revised §48(g) was intended to eliminate the rehabilitation credit for a building converted into an amusement park structure. This, however, is seems to be the result that is obtained.

Under revised §48(g)(2)(B), certain expenditures are excluded as "qualified rehabilitation expenditures" as under pre-1986 TRA law. The following amounts are excluded:

(i) Expenditures with respect to which an accelerated depreciation method is used.

(ii) The cost of acquiring any building or interest therein.

(iii) Any expenditure attributable to the enlargement of an existing building.

(iv) Any rehabilitation expenditure related to a certified historic structure or building in a registered historic district unless the rehabilitation is certified or the building is certified as not being historic.

(v) Any rehabilitation expenditure allocable to property that will be tax-exempt use property as defined in §168(h).

(vi) Any expenditure of a lessee of a building unless, on the date the rehabilitation is completed, the remaining lease term equals or exceeds the recovery period determined under revised §168(c). Thus, a lessee expenditure with respect to a commercial office building will not qualify unless the lease term is at least equal to the 31.5-year recovery period for nonresidential real property when the rehabilitation is completed.

[63] §168(c)(2)(G).
[64] Act §251.
[65] Revised §48(g)(2)(A)(iii).
[66] *Id.*

f. Certified Historic Rehabilitations

Revised §48(g)(3) restates in precisely the same fashion as pre-1986 TRA law the definition of "certified historic structure" and "registered historic district." However, in a change from pre-1986 TRA law, a basis reduction equal to the full amount of the 20% credit will be required under §48(q)(3). Only a 50% reduction was required under the pre-TRA 25% credit for historic structures.

3. Effective Dates

The revised rehabilitation credit rules apply generally to property placed in service after December 31, 1986.[67] However, transition rules provide for the application of the pre-1986 TRA rules if the rehabilitation is completed pursuant to a written contract that was binding on March 1, 1986. The old rules will also apply if the rehabilitated property was acquired before March 2, 1986, or is acquired pursuant to a written contract binding on March 1, 1986, if (i) the rehabilitation is completed pursuant to a binding, written pre-March 2, 1986, contract, (ii) certain applications were filed with the Interior Department before March 2, 1986, or (iii) the lesser of $1 million or 5% of the cost of the rehabilitation was incurred before March 2, 1986, or was committed to be incurred pursuant to a binding written pre-March 2 contract. To qualify under the transition rules, the property must be placed in service before January 1, 1994.

For property placed in service after 1986 under the transition rules, the 15% credit for 30-year old property must be reduced to 10%, and the 20% credit for 40-year old property must be reduced to 13%. Act §251(d)(5). No reduction is required under the transition rules in the 25% credit for certified historic property. Moreover, no reduction is required in a credit carryforward to years beginning after 1986 for the portion of a business credit that is attributable to the rehabilitation credit. This is in contrast to the reduction required in the portion of a business credit carryforward attributable to a regular investment credit or energy investment credit. The non-reduction rule is particularly beneficial for a taxpayer who has a credit carryforward consisting of regular and rehabilitation credits since the regular investment credit is considered to be absorbed first under new §49(c)(5)(C). This absorption rule will maximize the amount of the credit carryforward to post-1986 years deemed attributable to the rehabilitation credit.

Note: The rehabilitation credit may be subject to the nonrecourse financing limitation of §46(c)(8) and (9) for property placed in service after 1986. For an analysis of this limitation as well as other limitations that may apply to all credits, *see* Chapter 14 *infra*.

[67] Act §251(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 12

LOW-INCOME HOUSING CREDIT

George B. Delta, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

There is no low-income housing credit under pre-TRA law, but several other provisions relating to low and moderate-income housing are available. Among these benefits are 5-year rapid depreciation for rehabilitation expenditures for low-income housing, accelerated depreciation over 15 years, and an exemption from 10-year amortization of construction period interest and taxes under §189. The Tax Reform Act of 1986 ("TRA") repealed these tax breaks and replaced them with a credit for low-income housing.[1] Under the TRA, low-income housing generally is treated as residential rental property with a recovery period of 27.5 years. The cost of low-income housing is recovered using the straight line method of depreciation.[2] The rapid depreciation of rehabilitation expenditures under §167(k) also is repealed and construction period interest and taxes are subject to amortization. This chapter provides an overview of the low-income housing credit and its anticipated impact on low-income housing, specifically, whether the credit is likely to spur the production of additional low-income housing and to serve more effectively both low-income individuals and owners willing to provide affordable low-income housing.

II. Detailed Analysis

A. Overview

Section 252 of the TRA adds §42 to the Code, providing a low-income housing credit in an amount equal to the applicable percentage (described in II, C, below) of the "qualified basis" of each "qualified low-income building."[3] A qualified low-income building is one which at all times during the compliance period (a period of 15 years beginning on the first day of the first taxable year in which the credit is claimed) is part of a "qualified low-income housing project" to which §168, as amended by §201 of the TRA, applies.[4] A residential rental project is a qualified low-income housing project only if it meets: (i) either the 20-50 test, *i.e.*, at least 20% of the aggregate residential units in all existing buildings of the project are occupied by individuals with incomes of 50% or less of the area median, as adjusted for family size, or the 40-60 test, *i.e.*, at least 40% of the aggregate residential units in all existing buildings of the project are occupied by individuals with incomes of 60% or less of the area median, as adjusted for family size, whichever the taxpayer elects (once the election is made, it is irrevocable), (ii) the residential units described in (i) above are rent-restricted, *i.e.*, the gross rent paid (excluding rental assistance payments, but including all utilities except telephone) by families in units that are included in qualifying basis does not exceed 30% of the applicable qualifying income for a family its size, and (iii) the requirements of Code §142(d)(2)(B), (3), (4), (5), (6), and (7) are met in determining whether a project is a low-income housing project and a unit is a low-income unit (the unit is rent-restricted and the occupants meet either the 20-50 test or the 40-60 test).[5] The Conference Report refers to the 20-50 test and the 40-60 test as the "minimum set-aside."[6] The taxpayer must meet the minimum set-aside requirement within 12 months of the date a building (or rehabilitated property) is placed in service and at all times during the 15 year compliance period.[7]

Comment: The minimum set-aside requirement targets individuals having a smaller area median income than that allowed by pre-TRA law, under which a low-income unit was one that was held for occupancy by families having an income that did not exceed 80% of the area median income for that area, adjusted for family size.

B. Meeting the Minimum Set-Aside Requirement

All units comprising the minimum set-aside in a project must be suitable for occupancy, used on a nontransient basis, and are subject to the 30% gross rent limitation of §42(g) mentioned in paragraph II, A, above.[8] The owner of the project must elect to meet either the 20-50 or the 40-60 test when he places the project in service and must meet that test within 12 months of the date he places the building (or the rehabilitated property) in service. In meeting either test, students occupying units do not count as low-income tenants unless at least one of them is entitled to file a joint income tax return.[9] When two or more buildings

[1] Tax Reform Act of 1986, P.L. 99-841, §252, adding §42 to the Internal Revenue Code of 1986 (hereinafter cited by section only).
[2] §§168(b)(3) and (c) as amended by the TRA.
[3] §42(a); Conf. Rep. No. 841, 99th Cong., 2d Sess. 85-103 (1986) (hereinafter cited as the "Conf. Rep.").
[4] §§42(c)(2) and (i)(1).
[5] §§42(g)(1), (2), and (4); §42(i)(4). §142, added to the Code by Act §1301, is the successor to §103.
[6] Conf. Rep., (*supra*, footnote 3) at 93.
[7] §§42(c)(2), (g)(3), and (i)(1).
[8] §42(i)(3)(A) and (B).
[9] Conf. Rep. at 94.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

are placed in service on different dates as part of the same project, the minimum set-aside test is applied on a building-by-building basis. Thus, when a later building is placed in service, the owner of the project will not be meet either the 20-50 or the 40-60 test, whichever he has elected, with respect to the later building unless the project meets the elected test without regard to the later building on the date the owner places such later building in service, and the project meets the elected test on the later building within 12 months of the date the owner places it in service.[10]

The determination of whether a tenant qualifies for purposes of the minimum set-aside, whether such tenant continues to qualify for purposes of the set-aside, and other similar determinations of compliance are made by reference to §142(d).[11] The income of an individual and the median gross area income shall be determined in a manner consistent with the principles stated in §8 of the United States Housing Act of 1937 (the "Housing Act").[12] Thus, for a project which qualifies under the 20-50 test, a family of four meets this standard if it has income of no more than 50% of the area median income; a family of three meets this test if it has no more than 45% of the area median income; a family of two meets this test if it has no more than 40% of the area median income; and, a single individual meets this test if he has no more than 35% of the area median income. The income limits may be adjusted by the Secretary of the Treasury if determinations under §8 of the Housing Act do not accurately reflect that housing costs are unusually high in a given area relative to family income or if in a given area family income levels are unusually low.[13] Vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by low-income individuals for purposes of the minimum set-aside requirement and qualified basis as long as reasonable attempts are made to rent the unit and no other unit of comparable or smaller size is rented to a non-qualifying individual.[14]

The determination of whether a tenant's income exceeds the applicable income limit shall be made at least annually on the basis of the individual's current income. A qualified low-income tenant will continue to be such, notwithstanding minimal increases in his income. Thus, an individual that qualifies as a low-income tenant initially shall continue to qualify as long as his income does not increase to a level more than 40% above the maximum qualifying income, adjusted for family size. In addition, the level of the maximum qualifying income is adjusted annually.[15] If the tenant's income rises to a level in excess of 40% above the applicable income ceiling (or if the size of the tenant's family decreases so that a lower maximum family income applies to the tenant), however, that tenant no longer counts in determining whether the project satisfies the set-aside requirement.[16] If a project elects to satisfy a stricter set-aside requirement and significantly restricts the rents on the low-income units relative to the other residential units in the building (referred to as "deep rent skewing"), a special rule applies. Under this special rule, a low-income tenant will qualify as such as long as his income does not rise to a level in excess of 70% above the applicable income ceiling (or if the size of the tenant's family decreases so that a lower maximum family income applies to the tenant), and if the project ceases to comply with the set-aside requirement because of increases in existing tenants' income, no penalties are imposed if each available low-income unit is rented to tenants having incomes of 40% or less of the area median income, until the project is again in compliance.[17] A deep rent skewed project is one where at least 15% of all low-income units are occupied by tenants having incomes of 40% or less of the area median income, the average rent charged to tenants in rental units that are not low-income units is at least 3 times the average rent charged to tenants of low-income units of comparable size, and gross rent does not exceed 30% of the income limit applicable to the low-income individuals that occupy the unit.[18]

Observation: Due to the high cost of housing in New York City, §142(d)(6) contains a special rule that relaxes the definition of a qualified low-income housing project for projects in that city. Under this special rule, a project in New York City is a qualified low-income housing project if it meets a 25-60 test, that is, if at least 25% (as opposed to 40% under the general rule) of the aggregate residential units in the project are occupied by tenants with incomes 60% or less of the area median income.

C. *Credit Amount*

The low-income housing credit is claimed annually for a period of 10 years. Section 42(b)(2)(B) sets the credit rate so that the annualized credit amounts have a present value of: (1) 70% of the qualified basis of new buildings (defined under §42(i)(4) as buildings whose original use begins with the taxpayer) that are not federally subsidized, and (2) 30% of the qualified basis of new buildings that are federally subsidized and of existing buildings. Under §42(b)(2)(C), the discount rate for determining the present value in the computation of the 70% and 30% annualized credit amounts is equal to 72% of the applicable federal rate (AFR) for mid-term and long-term obligations. This discount rate is determined as of the month the taxpayer places the project in service and is compounded annually. The present value is determined on the last day of the first tax year of the 10 year credit period. For buildings placed in service in 1987, the applicable percentage is 9% for new buildings that are not federally subsidized, and 4% for new buildings that are federally subsidized and for existing buildings.[19] The 10 year credit period begins the taxable year during which the project is placed in service, or, at the taxpayer's election, the succeeding taxable year.[20] The election is irrevocable.

[10] §42(g)(3)(B).
[11] §42(g)(4); Conf. Rep. at 93-94.
[12] §142(d)(2)(B).
[13] Conf. Rep. at 94.
[14] Conf. Rep. at 94.
[15] §142(d)(3); Conf. Rep. at 93.
[16] *Id.*
[17] §142(d)(4)(A); Conf. Rep. at 93-94.
[18] §142(d)(4)(B); Conf. Rep. at 93.
[19] §§42(b)(1) and (2). The applicable percentage shall be determined by the Secretary of Treasury to conform to the 70% and 30% present value statutory guidelines for buildings placed in service after 1987 and shall be adjusted monthly. *See* Conf. Rep. at 88-89 for an elaboration of the computation of the credit percentage.
[20] §42(f)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The first year the taxpayer claims the credit, the allowable credit amount is determined using an averaging convention to reflect the number of months units comprising the qualified basis (discussed in II, D below) were occupied by low-income tenants during the taxable year.[21] For example, if one-half of the low-income units that the taxpayer included in eligible basis were occupied by low-income tenants in October, and the remainder were occupied in December, a calendar year taxpayer would adjust the allowable first year credit to reflect that low-income tenants occupied these units on the average for one-sixth of the year.[22] To the extent that this creates a reduction in the amount of the credit in the first year, an additional credit in the amount of the reduction is available in the eleventh year.[23] This first year adjustment does not affect the amount of the qualified basis for which the taxpayer claims a credit in subsequent years.

Comment: The cost of construction in urban areas is high, land is expensive, and the project may not retain much value after the 15 year compliance period. Consequently, if the owner of a low-income project must use the lower credit percentage because such project receives federal subsidies, it may not be economically feasible to construct low-income housing projects in urban locations. New low-income projects in rural areas that qualify to receive a federal subsidy under FHA §515, for example, may provide a good rate of return for investors even with the lower credit amount because such project is more likely to retain its value at the end of the 15 year compliance period.

D. Qualified Basis

The qualified basis amounts with respect to which the credit amount is computed are determined as the proportion of eligible basis in a qualified low-income building attributable to the low-income rental units. It is an amount equal to the applicable fraction (determined as of the close of the taxable year) of the eligible basis. The applicable fraction is the smaller of: (i) the unit fraction, the proportion of low-income units to all residential units, and (ii) the floor space fraction, the proportion of floor space of the low-income units to the floor space of all residential units.[24] Generally, in computing either fraction, low-income units are rent-restricted units that qualifying low-income tenants occupy, whereas residential units are all units, occupied or not.[25] The eligible basis of a new building is its adjusted basis.[26] For existing buildings acquired by purchase as defined in §179(d)(2), the eligible basis is the acquisition cost plus the cost of rehabilitation, if any, to such buildings incurred before the end of the first taxable year of the 10 year credit period, provided such rehabilitation is chargeable to capital account and is of a character subject to the allowance for depreciation.[27] There is no minimum rehabilitation requirement with respect to an existing building. However, if the taxpayer meets certain requirements (discussed below), rehabilitation expenditures will be treated as a new building and may qualify for the 70% present value credit.[28] Only the adjusted basis of the building (which is computed by taking into account all adjustments under §1016(a), except the adjustments in §§1016(a)(2) and (3) relating to depreciation deductions) is included in eligible basis.[29] The cost of land is excluded from the adjusted basis.[30]

Generally, the eligible basis of a building is determined at the time the building is placed in service.[31] For this purpose, rehabilitation expenditures are deemed to be placed in service at the close of the 24 month aggregation period (the 24 month period commencing with the date the taxpayer begins the rehabilitation).[32] Where the purchaser claims rehabilitation expenditures in connection with the acquisition of a building, the capital expenditures incurred through the end of the first year of the credit period are includible in eligible basis.[33] Therefore, since rehabilitation expenditures incurred within the 24 month aggregation period are deemed to be placed in service at the close of the 24 month period, such expenditures may be claimed at the close of the taxable year in which they are placed in service, or the following year, depending on the taxpayer's election.[34] An existing building that is purchased and any rehabilitation expenses incurred with respect to it do not qualify for the credit unless a period of at least 10 years lapses between the date of its acquisition by the taxpayer and the later of the date the taxpayer last placed the building in service and the date of the most recent "nonqualified substantial improvements," *i.e.*, substantial improvements for which the previous owner elected former §167(k) or pre-TRA §168, provided the taxpayer or a person related to the taxpayer as of the date the building was previously placed in service did not place such building in service.[35] Improvements are substantial only if they constitute at least 25% of the adjusted basis of such building during any 24-month period.[36] For purposes of determining whether 10 years have lapsed subsequent to the most recent substantial improvements, the date of the substantial improvement is the last day of the 24-month period referred to in the preceding sentence.[37] A placement in service as a result of a nontaxable exchange shall not be taken into account in computing the 10 year period discussed above.[38] Any other transfer will begin a new 10 year period.

Observation: No credit is allowed for existing buildings unless: (i) the owner purchased the building, (ii) the date of acquisition is 10 or more years after the building was last placed in service or the date of the most recent "nonquali-

[21] §42(f)(2).
[22] §42(f)(2)(A); Conf. Rep. at 91.
[23] §42(f)(2)(B).
[24] §42(c)(1).
[25] *Id.*; §42(i)(3)(A).
[26] §42(d)(1).
[27] §42(d)(2). The eligible basis for all other existing buildings not acquired by purchase is zero. §642(d)(2)(B)(ii).
[28] §§42(b)(3) and (e).
[29] §42(d)(4)(C).
[30] Conf. Rep. at 89.
[31] §42(d)(5)(A).
[32] §42(e)(4)(A).
[33] §42(d)(2); Conf. Rep. at 89.
[34] §§42(e)(4)(A) and (f)(1).
[35] §§42(d)(2)(B) and (D)(i)(I). The determination of whether the parties are related is made under §§267(b) or 707(b)(1), except that 10% is substituted for 50%.
[36] §42(d)(2)(D)(i)(III).
[37] §42(d)(2)(D)(i)(II).
[38] §42(d)(2)(D)(ii).

fied substantial improvements" as defined in the previous paragraph above, and (iii) the taxpayer (or a person related to the taxpayer within the meaning of §§267(b) or 707(b)(1), as modified for these purposes by §42(d)(2)(D)(iii)(II)) did not previously place the building in service when the building was previously placed in service. §42(d)(2)(B).

The Secretary of the Treasury may waive the requirement that at least 10 years lapse between the date the taxpayer acquired the building and the later of the date the building was last placed in service and the date of the most recent substantial improvements for which the previous owner elected former §167(k) or pre-TRA §168 if such building is federally assisted and the waiver is necessary to avert the assignment of the mortgage to the Department of Housing and Urban Development ("HUD") or the Farmers' Home Administration ("FHA"), to avert a claim against a federal mortgage insurance fund, or similar circumstances of financial distress.[39] A building is federally assisted if it is substantially assisted, financed, or operated under §8 of the Housing Act, §§221(d)(3) or 236 of the National Housing Act of 1934, or §515 of the Housing Act of 1949 (the FHA program).[40]

For purposes of low-income housing, residential rental property has the same definition as under §103. Thus, residential rental property includes residential rental units, facilities for use by tenants, and other facilities reasonably required by the project. Costs of the residential rental units in a building which are not low-income units may be included in the eligible basis only if they are not above the average quality standard of the low-income units.[41] The quality of units is comparable if the construction or acquisition costs are comparable, and if such units are provided in a similar proportion to both low-income tenants and other tenants. The taxpayer may not include rehabilitation expenditures in eligible basis if these expenditures improve any unit in the building beyond a level comparable with the low-income units. Eligible basis may include amenities, including personal property, only if they are comparable to the cost of amenities in the low-income units. Swimming pools, recreational facilities, parking areas, and other tenant facilities may be included in eligible basis if there is no separate charge for the use of these facilities, and they are available on a comparable basis to all the tenants in the project.[42] Residential rental property may qualify for the credit even though a portion of the building in which the residential rental units are located is used for commercial purposes. No portion of the cost of such nonresidential property may be included in the eligible basis, however. The cost of such mixed use facility is allocable consistent with Prop. Regs. §1.103-8(b)(4)(v).[43]

Eligible basis for any taxable year does not include the amount of any federal grant, regardless of whether the grant constitutes gross income.[44] A federal grant includes any grant that is funded in whole or in part by the federal government, to the extent it is funded with federal funds. Examples of such grants that are not includible in eligible basis include Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Housing Development Grants.[45] If any portion of the eligible basis that is attributable to new construction, or the eligible basis that is attributable to rehabilitation expenditures, is financed with federal subsidies, the qualified basis is eligible only for the 30% present value credit, unless the federal subsidies are excluded from eligible basis.[46] A federal subsidy is any obligation the interest on which is tax-exempt under §103, or a direct or indirect federal loan, if the interest rate on the loan is below the applicable federal rate.[47] Examples of such subsidies are loans under FHA §515, and a reduced interest rate loan attributable in part to a federal grant.[48] The determination of whether rehabilitation expenses are federally subsidized is made without regard to the source of financing for the construction or acquisition of the building to which the rehabilitation expenses are made. Thus, a federal loan or tax-exempt bond financing that a taxpayer assumes or continues upon purchase of existing housing is disregarded for purposes of the credit on rehabilitation expenses.[49]

The rehabilitation expenditures that a taxpayer incurs with respect to any building shall be treated as a separate new building, if they meet certain requirements.[50] Rehabilitation expenditures qualify as a new building for purposes of the 70% present value credit if the average of such expenditures is at least $2,000 per low-income unit over the 24 month rehabilitation period that begins on the date the taxpayer commences the rehabilitation.[51] The $2,000 minimum is computed as an average and includes all of the qualifying expenditures in a building. It does not require that the taxpayer actually incur $2,000 of rehabilitation expenses for each low-income unit.[52] The determination of whether the taxpayer has met the $2,000 minimum is made at the end of the first year of the credit period of 10 years.[53] Thus, under §42(f)(1), the determination of whether the taxpayer meets the $2,000 minimum for rehabilitation expenditures will be made at the close of the year in which the taxpayer places in service the rehabilitated property or the close of the following year, depending on which year the taxpayer has elected as the initial year of the credit period. Rehabilitation expenses are placed in service at the close of the 24 month rehabilitation period.[54] Rehabilitation expenditures do not include the cost of acquiring a building or any interest therein.

The taxpayer determines the qualified basis for the rehabilitation expenditures in the same fractional manner as for new construction or acquisition costs, even though all rehabilitation expenses are incurred in connection with low-income units. The applicable fraction with respect to

[39] §42(d)(6)(A).
[40] §42(d)(6)(B).
[41] §42(d)(3).
[42] *See, e.g.*, Regs. §1.103-8(b)(4)(iii).
[43] Conf. Rep. at 90.
[44] §42(d)(5)(B).
[45] Conf. Rep. at 91.
[46] §§42(b)(1) and (d)(4)(B); Conf. Rep. at 91.
[47] §42(i)(2)(A) and (C).
[48] Conf. Rep. at 91.
[49] *Id.*
[50] §42(e)(1).
[51] §42(e)(3)(A).
[52] Conf. Rep. at 90.
[53] §42(e)(3)(B).
[54] §42(e)(4)(A).

the rehabilitation expenses is the applicable fraction for the building with respect to which such expenses were incurred, notwithstanding the fact that such rehabilitation is treated as a new building.[55] Rehabilitation expenses may be included in the basis of a building even without a transfer of the building.[56] Where the rehabilitation is to a group of units, the Secretary of the Treasury may provide through regulations that that the group of units is treated as a new building.[57]

E. Additions to Qualified Basis

The qualified basis of a building may be increased after the initial determination only by reason of an increase in the number of the low-income units or in the floor space of such units.[58] Credits claimed on such additional qualified basis are determined using a credit percentage that is two-thirds of the applicable credit percentage for the initial qualified basis and must receive an allocation of credit authority (paragraph II, F, below). Unlike credits claimed on the initial qualified basis, credits that the taxpayer claims with respect to additions to qualified basis are allowable annually for the remainder of the 15 year compliance period, regardless of the year such additional qualified basis is determined. The additional basis is determined by reference to the original adjusted basis of the property without deducting allowable depreciation for the property.[59]

The credit amount is adjusted for the first year using averaging conventions to reflect the number of months that low-income tenants occupied the units comprising the additional qualifying basis during the year.[60] Unlike the allowable credit for the 10 year credit period, any reduction of the credit in the first year for additions to qualified basis may not be claimed in a later year.[61] This first year adjustment does not affect the amount of the qualified basis for which a credit is claimed in subsequent years during the compliance period.

F. State Low-Income Housing Credit Authority Limitation

Section 42(h) creates a state volume limitation on the number of new low-income housing credits that are issued annually. Generally, any building eligible for the credit must receive an allocation of credit authority from the state or local credit agency in whose jurisdiction the low-income housing project is located, *unless* the taxpayer finances it with the proceeds of a tax-exempt bond which received an allocation pursuant to the private activity bond limitation added by the TRA.[62] There is no state volume limitation for projects financed by such tax-exempt bonds and the taxpayer need obtain no credit authority. Credit allocations count against a state's annual credit authority limitation for the calendar year in which the credits are allocated.[63] Generally, credits subject to the state credit authority limitation include any credits attributable to expenditures not financed with tax-exempt bonds subject to the new private activity bond volume limitation in Code §146. In the case of a building financed with the proceeds of tax-exempt bonds that are subject to the bond volume limitation, if 70% or more of the aggregate basis of the building and the land on which the building stands is financed with such proceeds, no portion of the credits attributable to such building is subject to the credit authority limitation. If less than 70% of the aggregate basis is attributable to the building and the land on which the building stands, only credits attributable to those bond-financed expenditures are not subject to the credit authority limitation.[64]

A building must receive low-income credit authority allocated to it for the calendar year which includes the last day of the first year of the credit period.[65] Authority must be received from the credit agency in whose jurisdiction the qualifying low-income building is located.[66] The credit agency's authority is reduced by the amount of the credit percentage multiplied by the qualified basis granted by the credit agency for the building. The state housing credit agency may not carry over any unused portion of its housing credit dollar amount that it does not allocate in any year.[67] A credit agency's credit limitation authority is reduced by the maximum amount of the credit that it grants, whether or not the low-income project is ultimately eligible for this amount.[68] At least 10% of each state's credit authority limitation is set aside for projects of qualified nonprofit organizations, defined as §501(c)(3) or (4) organizations one of the exempt purposes of which is the fostering of low-income housing.[69]

Credit agencies may not condition allocation of credits to the source of financing for the qualifying low-income building. The Treasury Department may prescribe regulations that require credit recipients to pay a reasonable fee to cover the administrative expenses of the credit agency.[70] Agencies allocating the credit must file with the Treasury Department reports containing: (1) the maximum applicable percentage and qualified basis of each building, (2) any fees charged to credit recipients, (3) the aggregate amount of the credits issued, and (4) any other information required by the Secretary of the Treasury.[71] The state housing credit is phased out after 1989.[72]

G. Recapture of the Credit and Penalty for Noncompliance

Qualified residential rental projects must satisfy the §42(g) minimum set-aside requirement during the 15 year compliance period. Low-income units comprising the qualified basis on which additional credits are based must comply with all the requirements in the same manner as units satisfying the minimum set-aside requirements. Units in addition to those meeting the minimum set-aside requirement must continuously comply with the income require-

[55] §42(e)(4)(B).
[56] Conf. Rep. at 90.
[57] §42(e)(6).
[58] §42(f)(3).
[59] Conf. Rep. at 92.
[60] §42(f)(3)(B).
[61] *Cf.* paragraph II, C above.
[62] §§42(h)(1)-(4); Conf. Rep. at 98.
[63] §42(h)(2)(B).
[64] §42(h)(4).
[65] §42(h)(6)(B)(ii).
[66] §42(h)(6).
[67] §42(h)(6)(B)(i).
[68] Conf. Rep. at 101.
[69] §42(h)(5)(A) and (C).
[70] Conf. Rep. at 102.
[71] §42(l)(2).
[72] §42(n)(1).

ment. The penalty for a decrease in the amount of the qualified basis of the building at the close of the taxable year from the close of the last taxable year is the recapture of the credit with respect to the accelerated amount claimed for all previous years on the amount of the reduction in the qualified basis.[73]

If a building that is subject to the 15 year compliance period does not remain part of the low-income housing project during that entire period, there is recapture of the accelerated portion of the credits for the earlier years. Recapture events include noncompliance with the minimum set-aside, noncompliance with the gross rent requirement, a decrease in the qualifying basis of the project (even though the minimum set-aside continues to be satisfied), financing from tax-exempt bonds or from federal subsidies for the project, and any other similar events.[74]

As a general rule, any change in the ownership of the building is a recapture event. An exception is provided, however, if the seller posts a bond with the Secretary of the Treasury in a satisfactory amount and it can reasonably be expected that the purchaser of such building will continue to operate it as a low-income project during the balance of the compliance period.[75] Also, a partnership consisting of more than 35 individuals (or estates), may elect to be treated as the taxpayer, in which case no change in ownership will be deemed to occur for recapture purposes, provided that within a 12 month period at least 50% in value of the original ownership remains unchanged.[76] A reduction in basis by reason of a casualty is not a recapture event as long as the taxpayer restores such loss within a reasonable time.[77]

In the recapture year, the taxpayer may not claim the credit. The amount of recapture is the accelerated portion of the credits claimed in earlier years, with interest under §6621.[78] The accelerated portion of the credits in any year is the amount of credits for that year, less the amount which would have been allowed for that year if all credits had been allowed ratably over the 15 year compliance period.[79] Because credits on the initial qualified basis of a building are claimed over 10 years rather than the compliance period of 15 years, the amount of credit recaptured for noncompliance in the first 11 years is one-third of the credit for each year, plus interest.[80] Because credits claimed on additions to qualified basis are taken over 15 years (the credit percentage is two-thirds of the applicable percentage), there is no accelerated portion of credits attributable to additions to qualified basis.[81] If the maximum credit for which a project qualifies increases and then decreases, a last in first out rule applies in determining the order of the credit recapture. The Conference Report provides an example of the last in first out credit recapture rule. Assume a building qualifies under the 20-50 minimum set-aside, but in fact has 25% of its tenants earning 50% or less of area median income, and in Year 3 begins receiving a credit based on an additional 10% of the building so that the total qualifying basis for the credit is 35%. The credit amount on this additional 10% is two-thirds of the applicable credit percentage. If in Year 5 only 30% of the basis of the building qualifies, there is no recapture of the credits taken in previous years, because there is no accelerated portion of the credit amounts attributable to the 5% of the additions to qualified basis claimed since Year 3.[82]

If there are no additions to qualified basis and no previous recapture events, the credits are recaptured as follows (in addition to interest): one-third of the total credits for violations after the first year and before the end of the eleventh year, 4/15 after the eleventh year but prior to the expiration of the twelfth year, 1/5 after the twelfth year but prior to the expiration of the thirteenth year, 2/15 after the thirteenth year but prior to the expiration of the fourteenth year, 1/15 after the fourteenth year but prior to the expiration of the fifteenth year.[83] There is no credit recapture if the credits allowed under §42 were not used to reduce tax liability (*e.g.*, such credits may have been suspended under the passive loss rule of §469), however, the carryover of credits shall be adjusted.[84]

Example: If the taxpayer has elected to meet the 20-50 test and 30% of the tenants have incomes 50% or less of the area median income, the additional 10% of the tenants above the minimum set-aside must continue to meet the income requirement (*i.e.*, have incomes 50% or less of the area median income). If 5% of these tenants no longer meet the income requirement, recapture occurs, but only on the accelerated portion of the credit amounts allocable to the 5% basis of the project that is no longer eligible for the credit. Because the project continues to meet the 20-50 minimum set-aside, full recapture is not required. Should an additional 10% of these tenants fail to meet the 50% of area median income test in a subsequent year, the project would no longer comply with the minimum set-aside requirement, and full recapture would be required. The recapture equals one-third of the total of all the credits taken in previous years that were allocable to the 25% of the basis of the project that represented units that qualified as units occupied by tenants with incomes 50% or less of the area median income, with interest under §6621. The credits relating to the 5% of basis that were recaptured in a prior year are not taken into account again.

Within 90 days of the end of the first taxable year for which the taxpayer claims the credit, and for each subsequent year during the compliance period, the taxpayer must certify to the Secretary of the Treasury that the project has continuously complied with the set-aside requirement during the year, report the dollar amount of the qualified basis, the eligible basis, and the adjusted basis of the building, report the applicable credit percentage, whether he has elected to comply with the 20-50 or the 40-60 minimum set-aside test, report the maximum qualified basis that the

[73] §42(j)(1).
[74] §42(j); Conf. Rep. at 96.
[75] Conf. Rep. at 96.
[76] §42(j)(5); Conf. Rep. at 96.
[77] §42(j)(4)(E).
[78] §42(j)(2).
[79] §42(j)(3).
[80] Conf. Rep. at 96.
[81] *Id.*; §42(j)(4)(C).
[82] Conf. Rep. at 97.
[83] Conf. Rep. at 96-97.
[84] §42(j)(4)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

housing credit agency has permitted him to take into account and provide any other information that the Secretary of the Treasury deems necessary.[85]

Owners and operators of low-income housing projects on which they have claimed a credit must correct any noncompliance with the set-aside requirement or with a reduction in the qualified basis within a reasonable period after they discover or should have discovered such noncompliance.[86] If the taxpayer corrects the noncompliance within a reasonable time, there is no recapture. The Conference Report specifies that it does not contemplate the eviction of current tenants to return the project to compliance. However, each available residential unit of comparable or smaller size that becomes vacant while the project does not comply must be rented to qualifying low-income tenant before any are rented to other tenants until the building complies again.[87] Consequently, absent a disposition of the building, the event that will generally give rise to the penalty for noncompliance (credit recapture or a reduction in the allowable credit) will be rental of a unit to a tenant who is not a low-income tenant (other than temporary rental) during any period when the project does not comply with the set-aside requirement or the qualified basis amounts on which the credit is computed.[88]

H. Transferability of the Credit and At-Risk Limitation

A new owner of the property is eligible to continue to receive the credit as if the new owner were the original owner, using the same qualified basis and credit percentages that the original owner used. Rehabilitation expenditures on such property may qualify for a credit in the same manner as rehabilitation expenditures on other qualifying property. Except for a special rule for partnerships (paragraph II, G above), all dispositions of ownership interests in buildings are dispositions for purposes of recapture.[89] Unlike the earlier draft of the Senate Committee on Finance, there is no election for the new owner to assume the recapture liability for prior credits and to step into the shoes of the prior owner.[90]

The amount of the credit is subject to an at-risk limitation similar to the investment tax credit at-risk rules in the case of nonrecourse financing. However, §46(c)(8)(D)(ii)(II), providing that nonrecourse financing cannot exceed 80% of the credit base, does not apply to low-income housing. There is also an exception for lenders related to the buyer of low-income property.[91] Another exception exists where the loan (including seller financing) is no more than 60% of the basis of the property, and it is made by a charitable organization one of whose tax-exempt purposes includes the fostering of lowincome housing.[92] Furthermore, if the rate of interest for any financing by a qualifying charitable organization is below the applicable federal rate (AFR) less one percent, then the qualified basis to which the financing relates shall be reduced to reflect the present value of the payments of principal and interest, using the AFR as the discount rate.[93] There is a recapture of the credit should the borrower fail to repay fully with interest the financing provided by the charitable organization at the end of the 15 year compliance period.[94]

I. Coordination with the Passive Loss Rule

For purposes of the §469 passive loss rules, the credit (but not losses) for low-income housing is treated as arising from rental real estate activities in which the taxpayer actively participates.[95] Thus, the low-income housing credit is subject to the limitations imposed on credits from such activities, so that it is generally unavailable to offset tax attributable to income other than passive income.[96] As a result, even though new §42 provides a credit for low-income housing, in practice this credit is available only to taxpayers with passive activity income, such as rental income, for example.[97] Under special exception, however, a natural person may use low-income housing credits to offset tax on up to $25,000 of nonpassive income, subject to a phase-out between $200,000 and $250,000 of adjusted gross income (the $25,000 amount is reduced by one dollar for every two dollars over $200,000 of adjusted gross income of the taxpayer, computed without regard to passive losses).[98] The taxpayer does not have to actively participate in the low-income project to qualify for the $25,000 offset.[99] Thus, a limited partner in a partnership that owns low-income housing qualifies for the $25,000 offset. The basis of property is not reduced by the amount of low-income credits that the taxpayer claims.[100]

Observation: The credit is likely to be of limited utility to investors with adjusted gross incomes in excess of $200,000, unless they have significant amounts of passive income. This is important because the preferred investment vehicle for low-income housing projects has been the limited partnership. The practical inability of investors with adjusted gross incomes over $200,000 to use the low-income housing credit (unless such investors have passive activity income) reduces the pool of available investors. As a result, more low-income housing projects may have to be offered to the public to raise funds, with the expensive and cumbersome registration process that accompanies public offerings.

J. Transitional Relief from the Passive Loss Rule

Section 502 of the TRA provides some limited relief from the application of the passive loss rule for investors who had invested in low-income housing under pre-TRA law. Under this rule, any loss sustained by a qualified investor with respect to an interest in a qualified lowincome project for any taxable year in a "relief period" shall not be treated as a loss from a passive activity for purposes of §469.[101] A qualified investor is a natural person who holds

[85] §42(l)(1).
[86] Conf. Rep. at 97.
[87] *Id.*
[88] *Id.*
[89] Conf. Rep. at 102.
[90] §42(h) of §1413(a) of the Senate Finance Committee draft of the TRA (May 29, 1986).
[91] §42(k)(1). That section was amended by §8072 of the Omnibus Budget Reconciliation Act of 1986, H.R. 5300 (Oct. 17, 1986).
[92] §42(k)(2)(C).
[93] §42(k)(3).
[94] §42(k)(4).
[95] §469(i); Conf. Rep. at 103.
[96] §§469(a)(1) and (d)(2); §38(b)(5) as amended.
[97] §469(c)(2).
[98] §469(i)(3).
[99] §469(i)(6)(B).
[100] Conf. Rep. at 103.
[101] §502(a) of the TRA.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(directly or indirectly through an entity) an interest in a qualifying low-income project placed in service before August 17, 1986, if such investor: (1) made his initial investment in the project after 1983, or if the project was not placed in service before August 17, 1986, the investor held an interest in the project on December 31, 1986; and (2) is required to make payments after 1986 of 50% or more of his total original obligated investment in such project.[102] A person is treated as holding the interest if he had a binding contract to acquire such interest on the specified dates.[103] A qualified low-income project for purposes of the transitional rule retains its meaning under §1250(a)(1)(B), as under pre-TRA law.[104] The relief period is the period beginning with the taxable year in which the investor made his initial investment and ending the earliest of: (1) the sixth taxable year after the taxable year in which the investor made his initial investment, (2) the first taxable year after the taxable year in which the investor must make his final investment, and (3) the taxable year preceding the taxable year for which the project ceased to be a qualified low-income project under the meaning of §1250(a)(1)(B).[105] TRA §502(d)(3) provides that a person may not claim the low-income housing credit for any project, if such person has claimed relief from the passive loss rule pursuant to §502.

[102] §502(d)(1) of the TRA.
[103] *Id.*
[104] §502(c) of the TRA.
[105] §502(b) of the TRA.

Observation: This transitional relief from the passive loss rule for those who had invested in low-income projects under pre-TRA law treats investors who make a lump sum investment in a project differently from investors who contributed over a period of years. Thus, an investor who made his only investment in the project in one lump sum in 1985 receives no relief from the passive loss rule while an investor in the same project who made his initial investment also in 1985 and continues to make investments and is obligated to make them until 1988, is not subject to the passive loss rules through the end of 1989.[106] Congress made this distinction because of its concern that, without some relief from the passive loss rule, investors would default on their obligations to make additional contributions to low-income projects that they had invested in prior to the adoption of the passive loss rule.

K. Effective Date

The low-income housing credit is effective for projects placed in service in taxable years after 1986 (other than property grandfathered under the depreciation rules) and before 1990.[107] A building placed in service after 1989 is eligible for the credit if expenditures of 10% or more of the reasonably expected cost of the building are incurred prior to 1989, and the building is placed in service before 1991. Credit authority for such property placed in service in 1990 may be carried over from the 1989 volume allocation for the credit agency.[108]

[106] §502(d)(2) of the TRA.
[107] §252(e) of the TRA; §42(n)(1).
[108] §42(n)(2); Conf. Rep. at 103.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 13

EXTENSION AND MODIFICATION OF RESEARCH CREDIT RULES

James F. Miller, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

The Code §30 incremental research credit (commonly known as the "research and development credit") was enacted in 1981 to provide a substantial incentive for U.S. companies to allocate more of their resources to research and development.[1] As enacted by ERTA §221(a), the credit was 25% of the excess of (1) qualified research expenses for the taxable year incurred in carrying on a business over (2) the average amount of the taxpayer's yearly qualified research expenses in the preceding three taxable years (*i.e.*, the "base period"). The credit was temporary—available only for qualified research and development expenditures paid or incurred after June 30, 1981, and before January 1, 1986,—to enable Congress to evaluate its effectiveness and to determine whether it should be extended in its present or modified form.[2]

In 1986, after reviewing available information and testimony on its operation, Congress extended the credit for an additional four years "in order to obtain sufficient data and information to evaluate whether or not the credit should be further extended or modified." [3] However, Congress modified the application of the credit to encourage technological research that may develop new, innovative products. It established new rules designed to target the credit to high-tech activities and eliminate the ability of nontechnologically innovative activities to qualify for the credit.[4] Congress also added a new credit for "university basic research" because it "believe[d] it is desirable to provide increased tax incentives for corporate cash expenditures for university basic research where such expenditures do not merely represent a switching of donations from general university giving and where certain other maintenance-of-effort levels are exceeded." [5]

[1] *See* H.R. Rep. No. 201, 97th Cong., 1st Sess. 111 (1981). The research and development credit was originally added as Code §44F pursuant to §221 of the Economic Recovery Tax Act of 1981 (P.L. 97-34 or ERTA), but was renumbered as part of the tax credit simplification portion of the Tax Reform Act of 1984 (P.L. 98-369).

[2] ERTA §221(d)(1). *See* S. Rep. No. 313, 99th Cong., 2d Sess. 694 (1986) ("S. Rep.")

[3] S. Rep., 694.

[4] *See* S. Rep., p. 695.

[5] S. Rep., p. 695.

II. Overview

Section 231 of the TRA 1986 redesignates the old Code §30 as Code §41 and extends the incremental research credit for eligible expenses paid or incurred through 1988.

Under newly designated Code §41, the credit is reduced to 20% and the definition of qualified research is narrowed to include only research: (1) undertaken to discover information which is technological in nature and intended to be useful in development of a new or improved business component; and: (2) substantially all the activities of which constitute elements of a process of experimentation for functional purpose. *See* §41(d)(1) and (3).

The prior-law provision [6] under which rental or other payments for the right to use personal property in conducting qualified research are eligible for the credit is repealed, although under regulations to be prescribed by the Treasury, payments to persons other than the taxpayer for the right to use (time-sharing) a computer in the conduct of qualified research remains eligible for the incremental research credit to the extent allowable under present law. *See* §41(b)(2)(A)(iii).

The new law introduces a "university basic research credit" [7] equal to 20% of all basic research payments made to universities and certain other organizations in excess of a special base amount. §41(a)(2). The university basic research credit is available to any corporation other than an S corporation, a personal holding company or a service organization as defined in §414(m)(3).[8]

Section 231(d) of the TRA 1986 makes both the incremental research credit and the university basic research credit subject to the overall limitation that applies to general business tax credits (*i.e.*, credits can offset only 75% of tax liability over $25,000).[9]

Under a tough rule [10] applicable to sole proprietors, partners, beneficiaries of an estate or trust, and shareholders of S corporations, the incremental research credit may offset only the tax attributable to the taxpayer's interest in the trade or business that generated the credit.

[6] §30(b)(2)(A)(iii)).

[7] §41(e).

[8] Code §41(e)(7)(E).

[9] Code §38(b)(4), as amended by §221 of the TRA 1986.

[10] §41(g).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The amendments regarding the incremental research credit are effective for taxable years beginning after December 31, 1985. Act §231(g)(1). The university basic research credit is effective for taxable years beginning after December 31, 1986. Act §231(g)(3).

III. Detailed Analysis

A. Qualified Research

As under prior law, §41(d)(1)(A) limits qualified research to research with respect to which expenditures may be treated as expenses under §174. Thus, it relates to "research and development costs in the experimental or laboratory sense" and includes costs incidental to the development of an experimental or pilot model, a plant process, a product, a formula, an invention or similar property, and the improvement of already existing property of the type mentioned.[11] However, §41(d)(1) further limits qualified research to research "(B) which is undertaken for the purpose of discovering information — (i) which is technological in nature, and (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and (C) substantially all of the activities of which constitute elements of a process of experimentation for" a purpose described in §641(d)(3), *i.e.*, "(i) a new or improved function, (ii) performance, or (iii) reliability or quality."

1. Technological Nature

The Conference Report to the TRA 1986 clarifies that research is technological in nature if the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science including research intended to expand or refine existing principles of computer science).[12] For example, information relating to the development of new methodology for determining the rate of return on investments and for developing new methods of advertising presumably does not qualify because they are not based on physical sciences and, thus, are not technological in nature. *See* Conf. Rep., p. II-71-72.

2. Business Component

Under §41(d)(2)(B), the term business component is defined as "a product, process, computer software, technique, formula or invention" that is "held for sale, lease, or license," or "used by the taxpayer in a trade or business of the taxpayer." Code §41(d)(2)(C) clarifies that "[a]ny plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced)."

3. Process of Experimentation

The Conference Report defines the term process of experimentation as "a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset." [13] Under the experimentation element of the qualified research test, the process of experimentation must be for a purpose related to a new or improved function, performance, or reliability or quality.[14] However, research relating to style, taste, cosmetic or seasonal design factors does not qualify.[15]

Comment: The type of experiments undertaken by pharmaceutical companies in developing and testing a new drug generally qualify because they are part of a process of scientific experimentation necessary to develop the drug. Similarly, the design of a new computer system and the design of new or improved integrated circuits for use in a computer or other scientific products are qualified research expenditures. This is because the design is not known at the beginning of the research and final design can be determined only through a process of experimentation that relates to an idea that is developed into a final product through trial-and-error testing.

4. Application of Tests

Section 41(d)(2)(A) states that the analysis as to whether research is "qualified" for purposes of §41(d)(1) "shall be applied separately with respect to each business component of the taxpayer." The Conference Report elaborates by pointing out that "[i]f the requirements * * * [set forth in §41(d)(1)] are not met with respect to a product, etc., but are met with respect to one or more elements thereof, the term business component means the most significant set of elements of such product, etc. with respect to which all requirements are met." [16] For example, if research on a new automobile engine as a whole does not satisfy all the tests, the development of a specific component (*e.g.*, a new firing system) may qualify.

5. Activities for Which Credit Not Allowed

Code §41(d)(4) specifies that expenditures incurred for the following activities are excluded from eligibility for the credit (regardless of whether the requirements described above relating to technological information, experimentation and functional purposes are met):

(a) Activities with respect to a business component after the beginning of commercial production of the component;

(b) Adaptation of an existing business component to a particular customer's requirement or need;

(c) Efficiency surveys, management studies, management techniques, market research, market testing and development (including advertising or promotions), routine data collections, or routine or ordinary testing or inspection of materials or business items for quality control;

(d) Research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such component;

(e) Research with respect to computer software which is developed by (or for the benefit of) the taxpayer primar-

[11] Regs. §1.174-2(a)(1).
[12] H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-71. (1986) ("Conf. Rept.").
[13] Conf. Rept., p. II-72.
[14] Code §41(d)(3)(A).
[15] Code §41(d)(3)(B).
[16] Conf. Rept., p. II-72.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ily for internal use of the taxpayer, unless the software is used in (i) qualified research (other than the development of the internal-use software itself) undertaken by the taxpayer, (ii) a production process that meets the requirements for the credit, or (iii) any other research activity provided in Treasury regulations;[17]

(f) Research conducted outside the United States;

(g) Research in the social sciences, arts or humanities; and

(h) Research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

B. University Basic Research Credit

The university basic research credit set forth in §41(e) applies to the excess of (i) 100% of corporate cash expenditures for university basic research (*i.e.*, "basic research payments") over (ii) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation compared to such giving during a fixed base period, adjusted for inflation.

1. Qualifying Expenditures

Code §41(e)(2)(A) defines the term "basic research payment" as a cash expenditure paid pursuant to a written agreement between the taxpayer corporation and a university or certain other qualified organizations for "basic research" to be performed by the qualified organization (unless the recipient is a "scientific tax-exempt organization" or a specified "grant organization," as such terms are defined in §41(e)(6)(C) and (D), respectively). Code §41(e)(7)(A) defines "basic research" as any original investigation for the advancement of scientific knowledge not having a specific commercial objective, other than basic research in the social sciences, arts, or humanities or basic research conducted outside the United States.

2. Qualified Organizations

Section 41(e)(6) defines the term "qualified organizations" as including any of the following:

(a) "Educational institutions" that are described in §170(b)(1)(A)(ii) and constitute institutions of higher education within the meaning of §3304(f);

(b) "Certain scientific research organizations" that: (i) are organized and operated primarily to conduct scientific research, (ii) are described in §501(c)(3) (relating to exclusively charitable, educational, scientific, etc., organizations), and (iii) are not private foundations; and

(c) "Scientific tax-exempt organizations" organized and operated primarily to promote scientific research by colleges or universities pursuant to written research agreements, that expend on a current basis substantially all their funds (or all the basic research payments received by them) through grants and contracts for basic research by colleges and universities, and that are either (i) described in §501(c)(3) (other than a private foundation) or (ii) described in §501(c)(6) (trade associations).

3. Rules for Computing the University Basic Research Credit

The 20% university basic research credit applies to the excess of 100% of corporate basic research payments over the "qualified organization base period amount." Code §41(e)(1).

Code §41(e)(3) defines the term "qualified organization base period amount" as an amount equal to the sum of the "minimum basic research amount" plus the "maintenance-of-effort amount."

Code §41(e)(4) defines the "minimum basic research amount" as an amount equal to the greater of two fixed floors—

(i) One percent of the average of the sum of all in-house research expenses, contract research expenses, and credit-eligible basic research expenditures under former §30(e)(1) during the three taxable years immediately preceding the taxable year beginning after December 31, 1983 (*i.e.*, the "base period" as defined in §41(e)(7)(B)); and

(ii) the average of all credit-eligible basic research expenditures under old §30(e)(1) during the base period. *See* H.R. Rep. No. 426, 99th Cong., 1st Sess. 184 (1985)("House Report").

In the case of a corporation that was not in existence for at least one full year during a taxable year (other than a short taxable year) in the base period, §41(e)(4)(B) provides that the "minimum basic research amount" for the base period will not be less than 50% of the basic research payments for the current taxable year. If the corporation was in existence for one or two the base-period years, the fixed floor is to be computed with respect to such year or years. *See* House Report at 184.

Code §41(e)(5)(A) defines the "maintenance-of-effort amount" for any taxable year as the excess of: (i) the average of the "nondesignated university donations" made during the base period (as defined above), as adjusted by the §1 cost-of-living factor for the calendar year in which the such taxable year begins; over (ii) the amount of nondesignated university donations paid by the taxpayer in such taxable year. Code §41(e)(5)(B) defines "nondesignated university donations" as all amounts paid by the taxpayer to all colleges or universities for which a charitable deduction was allowable and that were not taken into account in computing the research credit.

C. Interplay of Incremental Research Credit and University Basic Research Credit

The amount of basic research payments to which the university basic research credit applies does not enter into the computation of the incremental research credit. Under §41(e)(1)(B), the portion of basic research payments which to which the university basic research credit does not apply (*i.e.*, the portion not exceeding the "qualified organization

[17] For example, if a taxpayer is developing robotics and related software for use in operating a manufacturing process, the taxpayer's cost of developing the software should be eligible for the credit. Software developed for internal use in administrative, financial or bookkeeping functions is generally not eligible, except when the software is truly "technologically innovative."

base period amount") enters into the incremental research computation (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

Example: X Corp.'s qualified research expenses exceed base period research expenses by $200,000. It has a total of $100,000 in basic research payments. Assume the basic research floor amount is $40,000. Result: X Corp. may claim a $12,000 credit for basic research (*i.e.*, $100,000 minus $40,000, times 20%). X Corp. may also claim a $48,000 credit for qualified research expenses ($200,000 of qualified research expenses, plus $40,000 of basic research expenses for which the new credit was not claimed, times 20%). The total research credit, therefore, is $60,000.

D. Other Limits on the Credit

The research and development credit is not allowed against the alternative minimum tax (the "AMT"). *See* Code §55(b)(1). In addition, as a practical matter, the credit is further limited by the AMT because the credit can reduce a taxpayer's regular-tax liability only to the amount it would pay under the AMT.[18]

[18] Code §26(a), as amended by §701(c)(1)(A) of the TRA 1986.

The credit is also subject to the overall limitation that applies to general business tax credits, *i.e.*, credits can offset only 75% of tax liability over $25,000.[19]

A tough new rule applies to sole proprietors, partners, beneficiaries of an estate or trust, and shareholders of S corporations: the credit may offset only the tax attributable to the taxpayer's interest in the trade or business that generated the credit.[20]

Comment: This credit limitation is much harsher than the general credit limit imposed by the new passive-loss rules.[21] The general limit restricts passive-source credits to tax owed on "passive activity" income only if the taxpayer does not materially participate in the activity. The limit on research credits applies whether or not the taxpayer materially participates in the trade or business that gives rise to the credits.

[19] Code §38(c)(1), amended by §221 of the TRA 1986. *See* amended Code §38(b)(4).

[20] §41(g).

[21] Code §469, added by §501 of the TRA 1986.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 14

MISCELLANEOUS CREDITS

Jane M. Eldredge, Esq.
Patrick G. Dooher, Esq.
Silverstein and Mullens
Washington, D.C.

I. Extension and Modification of Targeted Jobs Credit

A. Introduction

Under pre-TRA 1986 law, the targeted jobs credit was due to expire December 31, 1985.[1] The targeted jobs credit had been equal to 50% of the qualified first year's wages of an employee who belonged to one of the nine targeted groups, up to a maximum of $6,000 of wages per individual and 25% of the qualified second year wages.[2] The "first year" was calculated from the day the employee started work for the employer. A credit equal to 85% of up to $3,000 of wages of a qualified summer youth employee also was allowed.

The nine targeted groups for whom the credit was available were (1) vocational rehabilitation referrals; (2) economically disadvantaged youths (ages 18-24); (3) economically disadvantaged Vietnam-era veterans; (4) supplemental security income recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students (ages 16-19); (7) economically disadvantaged former convicts; (8) AFDC recipients and WIN registrants; and (9) economically disadvantaged summer youth employees (ages 16-17).[3] However, an individual was only treated as a member of a target group if on or before the employee's first day of employment, the employer made a written request to a designated local agency seeking a certification or had received a certification that the individual was a member of a "targeted group."[4]

B. Analysis

Although Congress extended the target jobs credit for another three years, making it available for wages paid to individuals who started work on or before December 31, 1988, it did not provide for retroactive certification for individuals who were employed between January 1, 1986 and October 22, 1986.[5] In addition, the maximum credit for the first year's wages was reduced from 50% to 40% of the individual's wages up to maximum of $6,000, thereby reducing the maximum allowable credit from $3,000 to $2,400.[6] The Act makes the credit available for first year wages only, not for any second year wages.

Under new Code §51(i)(3), the availability of the credit for non-summer employees is only for wages of individuals who have at least 90 days of employment, or who have completed at least 120 hours of work. Wages for a shorter work-period are not eligible for the targeted jobs credit.

The targeted jobs credit for wages paid to qualified summer youth employees is retained at 85% of the wages, up to a maximum of $3,000 of wages or a maximum credit of $2,550. However, the Act limits the availability of the credit to wages of a summer employee who has worked for at least 14 days or completed at least 20 hours of work.[7]

C. Effective Date

The extension and modification of §51 of the Code is retroactive to December 31, 1985.[8]

II. Alternative Minimum Tax Credit

A. Introduction

Under the minimum tax rules in effect prior to the enactment of the 1986 TRA, noncorporate taxpayers were subject to the alternative minimum tax to the extent that tax exceeds the taxpayer's regular tax for the taxable year. In general, the pre-1986 TRA alternative minimum tax was equal to 20% of alternative minimum taxable income. Alternative minimum taxable income, in turn, is equal to adjusted gross income, increased by certain tax preferences and decreased by alternative tax itemized deductions and an alternative minimum tax exemption amount.

Prior to the 1986 TRA, corporations could be liable for the add-on minimum tax of §56. This tax was equal to 15% of the corporation's tax preferences for the taxable year, to the extent those tax preferences exceed the greater of (i) $10,000 or (ii) the corporation's regular income tax.

---

[1] Pre-TRA 1986 Code §51(c)(3). All code section references are to the Internal Revenue Code of 1986 unless otherwise indicated.
[2] Pre-TRA Code §51(a).
[3] Pre-TRA Code §51(d).
[4] Pre-TRA Code §51(d)(2)-(12).
[5] Act §1701(a). Thus, if employees hired during this time period had not been certified as members of a targeted group pursuant to the special certification rules under §51(d)(16), the employer is ineligible for retroactive application of the job credit.
[6] Act §1701(b). Amended Code §51(a).
[7] New Code §51(i)(3); Act §1701(c).
[8] Act §1701(e).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The list of pre-TRA tax preferences, which could increase noncorporate alternative minimum taxable income or subject a corporation to the add-on minimum tax, was set forth in pre-TRA §57. Some of the preferences listed in §57, however, applied only to noncorporate taxpayers.

One potentially unfair aspect of the pre-1986 TRA minimum tax rules is that the alternative minimum tax and minimum tax may be imposed on preferences that simply reflect timing differences. For example, 19-year real property will yield the same total amount of cost recovery deductions under §168 over the prescribed recovery period, regardless of whether accelerated or straight line rates are employed. Under pre-TRA §57(a)(12), however, accelerated cost recovery on 19-year real property was treated as a preference for purposes of both the noncorporate alternative minimum tax and the corporate add-on minimum tax. It is a preference to the extent the accelerated deduction for the taxable year exceeds the deduction that would have been computed using the straight-line method for such property. Generally, a preference would result for the first six to seven years that the 19-year real property was in service, and an alternative minimum tax or add-on minimum tax might be imposed on the preference for one or more of those years. In the ensuing years, the straight-line cost recovery deduction would exceed the deduction using the accelerated rates because of the front-loading of the deductions in the first six to seven years. No compensating adjustment or credit, however, was provided in the ensuing years for regular tax purposes even though a minimum tax or alternative minimum tax may have been paid with respect to the front-loaded ACRS deductions by reason of the §57(a)(12) preference.

B. Overview of 1986 TRA Minimum Tax Credit

Effective for taxable years beginning after December 31, 1986, the 1986 TRA [9] completely revised the alternative minimum tax and extended the revised alternative minimum tax to corporate as well as noncorporate taxpayers. The Act completely repealed the §56 add-on corporate minimum.

The revised alternative minimum tax continues to be imposed only to the extent that it exceeds a taxpayer's regular tax for the taxable year. For corporations, the alternative minimum tax is 20% of alternative minimum taxable income reduced by a $40,000 exemption amount that is subject to phase-out when alternative minimum taxable income exceeds $150,000. The noncorporate alternative minimum tax is similarly computed but at a 21% rate with varying exemptions and phase-out thresholds.[10]

For both corporate and noncorporate taxpayers, alternative minimum taxable income is computed by taking taxable income, adjusting that income by the adjustments prescribed in §§56 and 58, and increasing the adjusted income by the preferences listed in §57. The adjustments required by §§56 and 58 may include a recomputed depreciation deduction based upon the alternative depreciation system of revised Code §168 or may include the substitution of a different accounting method, such as the percentage of completion method for the completed contract method. The adjustments are consistently applied for alternative minimum tax purposes from year-to-year. For example, if income is reported for year one using the percentage of completion method for minimum tax purposes, and if the same income is picked up for year two using the completed contract method for regular tax purposes, that income will not again be reported for minimum tax purposes in year two in computing alternative minimum taxable income. Rather, it will be subtracted from taxable income as an adjustment in arriving at alternative minimum taxable income for year two.

Note: The revised alternative minimum tax is fully analyzed in Chapters 32 and 33 of this portfolio.

In a significant change from pre-1986 TRA law, a minimum tax credit may become available if a minimum tax is paid as a result of timing differences. This credit, provided in Code §53,[11] will be available to the extent the alternative minimum tax liability incurred is due to timing differences, either because an item of income is reported more rapidly for alternative minimum tax purposes or because a deduction is taken into account more slowly for alternative minimum tax purposes. The minimum tax credit is available as an unlimited carryforward to ensuing years. The credit will be allowed to offset regular tax in any ensuing taxable year but only if, and to the extent that, the regular tax exceeds tentative minimum tax liability for the year.

C. Analysis of Minimum Tax Credit

1. Computation of Credit

Section 53(a) provides for the allowance of a minimum tax credit. Section 53(b) defines this credit as the excess, if any, of "the adjusted net minimum tax" imposed for all prior taxable years beginning after 1986 over the amount allowable as a credit in prior taxable years. Under §53(d), the "adjusted net minimum tax" for a taxable year is the net minimum tax imposed by §55 for that year reduced by the minimum tax liability that would have arisen for that year if the only adjustments and tax preference items taken into account in that year were "exclusion preferences."

The adjustments and preference items specified as "exclusion preferences" are:

(i) The itemized deductions allowed individuals by §56(b)(1), which includes such items as medical expenses and casualty losses;

(ii) The special deduction of §833(b) allowed Blue Cross and Blue Shield and similar health insurance organizations;

(iii) The percentage depreciation preference of §57(a)(1);

---

[9] Act §701.

[10] Under §55(d), the exemption amount is $40,000 for a joint return, $30,000 for a single taxpayer, and $20,000 for a married person filing a separate return or an estate or trust. The phase-out of the exemption begins at $150,000 of alternative minimum taxable income for a joint return, $112,500 for single taxpayers, $75,000 for married persons filing separately and estates and trusts. The phase-out is equal to 25% of each dollar of alternative minimum taxable income exceeding the applicable threshold amount.

[11] Added by Act §701(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(iv) The tax preference for tax-exempt interest on certain private activity bonds described in §57(a)(5);

(v) The tax preference for the charitable contribution of appreciated property described in §57(a)(6);

(vi) For taxable years beginning after 1989, the special earnings and profits adjustments for corporations set forth in §56(g) to the extent excluded from gross income for any taxable year for regular tax purposes or not deductible for any taxable year for purposes of §56(g).

Note: Although the book income preference of §56(c)(1) for corporations for taxable years beginning in 1987, 1988, 1989, may result from exclusion items such as tax-exempt interest, the book income adjustment is not adjusted to eliminate such exclusion preferences.[12] Thus, the full amount of the book income adjustment may be taken into account in determining the amount of the minimum tax credit.

Although the exclusion preferences are not allowed for purposes of the minimum tax credit, the computation under which they are eliminated from the credit computation is quite favorable. Only if an alternative minimum tax would be imposed for the taxable year solely because of the existence of the exclusion preferences will the minimum tax credit be subject to a cutback because of such preferences. The following three examples, the last of which is derived from the Senate Finance Committee Report,[13] demonstrate the beneficial effect of this computation:

Example (1): Assume that a married couple filing a joint return for 1988 (i) has zero regular taxable income, (ii) in arriving at zero taxable income has deducted itemized deductions of $15,000 that are disallowed for alternative minimum tax purposes by §56(b)(1) and has deducted the $5,000 standard deduction that is also denied under §56(b)(1) for minimum tax purposes, and (iii) has realized a $500,000 deferred installment sales profit that must be reported in full for minimum tax purposes as an adjustment under §56(a)(6). Their alternative minimum taxable income based on the foregoing facts is $520,000 for 1988, and their tentative alternative minimum tax at a 21% rate equals $109,200. Since they owe no regular tax on the zero taxable income, the $109,200 becomes their alternative minimum tax for 1988. For purposes of computing the credit, the $500,000 of deferred installment sales gain is not an exclusion preference, but the $20,000 §56(b)(1) adjustment is such a preference. To determine the reduction in the §53 credit for the exclusion preference, the alternative minimum tax must be recomputed by taking into account only the exclusion preference, in this case $20,000. Recomputed alternative minimum taxable income would therefore equal the couple's zero taxable income for regular tax purposes plus the $20,000 exclusion preference. However, no alternative minimum tax would be owed on this $20,000 of alternative minimum taxable income because the $40,000 exemption amount would reduce that income to zero. Although the exemption amount was completely phased-out in computing the $109,200 alternative minimum tax on the $520,000 of alternative minimum taxable income, no phase-out of the $40,000 exemption amount occurs when alternative minimum taxable income is only $20,000. Thus, there is no reduction in the §53 credit for exclusion preferences, and the credit equals the full amount of the minimum tax of $109,200.

Observation: The example in the Senate Finance Committee Report set forth as Example (3) below confirms that the recomputation of the alternative minimum tax using only exclusion preferences is made without regard to any exemption phase-out that may have occurred in arriving at the net alternative minimum tax.

Example (2): Assume that a married couple filing a joint return for 1988 has taxable income of $200,000 and that the tax on this income at a 28% flat rate equals $56,000 because of the phase-out of the lower bracket rates and personal exemptions. Further assume that the couple has a $35,000 tax-exempt interest preference under §57(a)(5) and a $500,000 deferred installment sales gain for 1988 . Adding back the 1988 standard deduction of $5,000, the couple's total alternative minimum taxable income will equal $740,000 ($200,000 + $5,000 + $35,000 + $500,000). The tentative alternative minimum tax on this $740,000 is $155,400 at a 21% rate. To arrive at the net alternative minimum tax, the $56,000 regular tax is subtracted from the $155,400 tentative alternative minimum tax to yield a net $99,400 alternative minimum tax. To compute the minimum tax credit, the alternative minimum tax is recomputed taking into account only the tax-exempt interest and the standard deduction. Recomputed alternative minimum taxable income equals $240,000 ($200,000 + $5,000 + $35,000) less a $17,500 exemption amount (which has been partially phased out because alternative minimum taxable income exceeds the $150,000 joint return phase-out threshold). Thus, the recomputed tentative alternative minimum tax is 21% of $222,500 or $46,725. However, this $46,725 tentative alternative minimum tax does not give rise to alternative minimum tax liability because the $56,000 regular tax exceeds this tentative tax. Consequently, there is no reduction for the exclusion preferences, and the minimum tax credit therefore equals the $99,400 net alternative minimum tax.

Example (3): Assume that for 1988 a married couple filing a joint return has no taxable income, an installment sales gain adjustment of $400,000, and exclusion preferences of $100,000. Total alternative minimum taxable income equals $500,000, which at a 21% rate yields a $105,000 alternative minimum tax. Recomputing the alternative minimum tax taking into account only the exclusion preferences of $100,000 yields an alternative minimum tax of $12,600 (.21% of ($100,000 reduced by $40,000 exemption)). Thus, the minimum tax credit is $92,400 ($100,000 reduced by $12,600).

[12] S. Rep. No. 313, 99th Cong., 2d Sess. 536, n. 12 (1986) ("Senate Report").
[13] *Id.*, at 536.

2. Application of Credit

The §53 credit is available as a carryforward to offset regular tax liability indefinitely.[14] Because it is available as an indefinite carryforward, it is unnecessary for a taxpayer to determine which prior year's minimum tax credit is being used in a particular year.[15]

Under §53(c)(1), a minimum tax credit carried to a particular taxable year may only offset the taxpayer's regular tax liability for that year, as reduced by other nonrefundable credits set forth in subparts A, B, and D of Part IV, dealing with the credit provisions of the Code.[16] In other words, only regular tax liability remaining after the application of other nonrefundable credits may be offset by the minimum tax credit. This rule, however, is favorable since the other nonrefundable credits are generally subject to more stringent limitations on their use than the minimum tax credit. For example, the general business credit of §38 is provided a carryover period of 18 years under §39 (three years back, 15 years forward); the minimum tax credit is allowed indefinitely.

The one additional limitation on the minimum tax credit, set forth in §53(c)(2), is that the minimum tax credit may not reduce a taxpayer's tax liability for a year below the tentative minimum tax for that year. The tentative minimum is defined in §55(b) as the gross minimum tax reduced by the alternative minimum foreign tax credit for the taxable year. For example, if the taxpayer for a taxable year has a $30,000 minimum tax credit, a $40,000 regular tax liability, and a $20,000 tentative minimum tax liability, the taxpayer may apply only $20,000 of the $30,000 minimum tax credit against the $40,000 regular tax liability. The $20,000 tentative minimum tax liability limits further use of the minimum tax credit. The $10,000 not allowed because of the tentative minimum tax limitation is carried forward to future taxable years.

Observation: The §53 minimum tax credit, in conjunction with the adjustments made in computing alternative minimum taxable income, should eliminate much of the penalty aspects of the minimum tax, at least to the extent that the minimum tax is not attributable exclusion preferences. For instance, in Example (1) above, if the taxpayers reported the $500,000 gain for regular tax purposes in 1988, the year that the sale occurred, their net regular tax liability would have been $138,600 ($500,000 minus the $5,000 standard deduction multiplied by 28%). If, instead, it is further assumed that the taxpayers report $500,000 deferred gain in 1989 for regular tax purposes, their regular tax liability for 1989, assuming a continuation of the 28% rate and no increase in the standard deduction, will be $138,600. Against this $138,600 regular tax, the taxpayers will have available as a carryforward the $109,200 minimum tax paid in 1988. Thus, for 1989, they will owe only an additional $29,400 in tax. The aggregate two-year tax consisting of the $109,200 alternative minimum tax for 1988 and the net $29,400 regular tax for 1989 equals the $138,600 the taxpayers would have paid if the gain had been reported in full for 1988. There is no minimum tax for 1989 under the foregoing facts because, for minimum tax purposes, the $500,000 of installment sales gain was completely reported in the preceding year, 1988, and is therefore subtracted in arriving at alternative minimum taxable income for 1989.

3. Corporate Acquisitions

Any unused minimum tax credit carryforward of a corporation that is acquired in a tax-free reorganization or liquidation to which §381(a) applies may be taken into account by the acquiring corporation.[17] Use of the acquired corporation's unused minimum tax credit, however, may be subject to limitation by revised §§382 and 383.[18] For a discussion of the limitations under revised §§382 and 383, *see* Chapter 35, *infra*.

III. Extension of Orphan Drug Credit

A. Introduction

A tax credit of 50% of the qualified clinical testing expenses during a taxable year is allowed [19] for testing related to the use of a drug for a rare disease or condition for which it was designated under §526 of the Federal Food, Drug and Cosmetic Act.[20] These drugs are "orphan" drugs because the rare diseases or conditions which they are intended to treat occur so infrequently in the United States, that it is economically not feasible for a company to recover the costs of testing drugs to treat it. In order to be eligible for the credit, the "orphan drugs" must be designated as such under §526 of the Federal Food, Drug and Cosmetic Act.[21]

B. Extension of Orphan Drug Credit

TRA 1986 extends the orphan drug credit for 50% of the expenses incurred in clinical testing of "orphan drugs" through December 31, 1990.[22]

IV. Increase in Earned Income Credit

A. Introduction

Since 1975, the Code has contained the earned income credit which "is intended to provide tax relief to low-income working individuals with children and to improve incentives to work." [23] Under pre-TRA 1986 law the credit was equal to 11% of the first $5,000 of earned income of an "eligible individual" up to a maximum credit of $550.[24] The amount of the availabale credit was phased-out between $6,500 and $11,000 of the individual's adjusted gross income (AGI) (or, if greater, the earned income).[25]

An "eligible individual" was either (1) married, with at least one dependent child; (2) a surviving spouse maintain-

[14] §53(b)(1); Senate Report, *supra*.
[15] *Id.*
[16] §53(c) also refers to Subparts E and F; however, Subparts E and F only set forth computational rules for determining constituent credits under the general business credit allowed by Subpart D.
[17] Senate Report, *supra*.
[18] *Id.*
[19] Code §28(a).
[20] Code §28(b)(2)(B).
[21] Pre-TRA 1986 Code §28(d).
[22] Act §232. Amended Code §28(e).
[23] H.R. Rep. No. 426, 99th Cong., 1st Sess. 94 (1985).
[24] Pre-TRA Code §32(b).
[25] Pre-TRA Code §32(b).

ing a household for a dependent child; or (3) an unmarried head of household with a dependent child.[26] The dependent child must reside with the individual for more than one-half of the taxable year, in order for the taxpayer to be eligible for the credit.[27]

Tables are provided for the taxpayer to impute the amount of the available credit.[28] The credit may be paid to eligible individuals directly in their paychecks during the year, if they elect advance payments;[29] or claimed as a credit on an income tax form.

B. Analysis

1. Increased Amount of Credit

The Act increases the rate of the credit from 11% to 14% of the base amount of earnings.[30] The Act also amends the base amount from $5,000 to $5,714 for 1987, thereby increasing the maximum credit from $550 to $800.[31]

Under amended §32(b), the credit phase-out begins at $9,000 of earnings, and is completely phased out at earnings of $17,000. The increase of the earnings level for which the phase-out of the credit begins is effective for taxable years beginning after 1987.

2. Inflation Adjustments

The Act created new Code §32(i) which is an inflation adjustment which allows the income base and the starting phase-out period to be adjusted each successive year by multiplying the income base by the cost-of-living adjustment determined under §1(f)(3).[32] All amounts will be rounded up to the nearest $10.[33]

3. Employee Notification

The Secretary of the Treasury is directed to promulgate regulations requiring employers to notify employees (other than students with summer jobs) who have not had any tax withheld from their wages that they may be eligible for refunds due to the earned income credit.[34]

V. Repeal of Political Contributions Tax Credit

A. Introduction

Under pre-TRA 1986 tax law, individuals were eligible to claim a credit against their income tax of 50% of their political contributions and newsletter fund contributions, up to a maximum credit of $50 per individual. A $100 maximum credit was allowed for a married couple filing a joint return.[35]

B. Analysis

Section 112 of the Act repeals Code §24 providing for the political contributions tax credit, effective for taxable years beginning on or after January 1, 1987. The Senate report stated that with the reduction in tax rates, the base-broadening of tax reform, the lack of incentive for those with no tax liability to make political contributions, the relatively high incomes of those who use the credit and the costliness of verification of the contributions were sufficient reasons for repealing the political contributions credit.[36]

---

[26] Pre-TRA Code §32(c)(1).
[27] Pre-TRA Code §32(c)(1)(B).
[28] Code §32(f).
[29] Code §3507.
[30] Code §32(a). Act §111(a)(1).
[31] Code §32(a). Act §111(a)(2).
[32] Act §111(c).
[33] Act §111(c); Code §32(i)(3).
[34] Act §111(e).
[35] Pre-TRA Code §24.
[36] S. Rep. No. 313, 99th Cong., 2d Sess. 86 (1986).

Chapter 15

NEW OR REVISED CREDIT LIMITATIONS

Patrick G. Dooher, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. Nonrefundable Personal Credits

The credits that may be applied to offset a taxpayer's tax liability for a taxable year are generally found in Part IV of Subchapter A of the Code, §§21 through 52. These credits may be grouped into two broad categories, refundable credits, which as the name implies are refunded if they exceed the taxpayer's tax liability for the year, and nonrefundable credits, which may be applied only to offset tax liability. The Code divides the nonrefundable credits into three subgroups: personal credits, miscellaneous credits, and business credits.

Prior to miscellaneous amendments by the 1986 TRA, the nonrefundable personal credits set forth in Subpart A of Part IV are as follows:

Description	*Code Section*
Household and Dependent Care	§21
Elderly and Disabled	§22
Residential Energy	§23
Political Contribution	§24
Mortgage Certificate	§25

The foregoing Subpart A personal credits are subject to a tax liability limitation contained in §26. Under §26, the sum of the nonrefundable personal credits for a taxable year cannot exceed the taxpayer's tax liability for that year. Section 26(b) defines "tax liability" as the tax imposed under the income tax provisions for the taxable year, with the exception of eight penalty-type taxes. The excluded penalty taxes, which cannot be offset by nonrefundable credits, are:

(i) The corporate minimum tax of §56,

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

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

(iv) The accumulated earnings tax of §531,

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

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

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

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

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

B. Miscellaneous Credits

Certain so-called "Miscellaneous Credits" are set forth in Subpart B of Part IV. These credits, also nonrefundable, are as follows:

Description	*Code Section*
Foreign and Possession Taxes	§27
Clinical Testing	§28
Nonconventional Fuels	§29
Research	§30

The §27 foreign and possession tax credit is subject to special limitations set forth in §901. The clinical testing credit and the nonconventional fuels credit are subject to the tax liability limitation of §26, as reduced by any nonrefundable credits allowed by Subpart A for the taxable year.

The research credit, prior to its revision by the 1986 TRA, is also subject to the §26 tax liability limitation, reduced by the nonrefundable personal credits of Subpart A and the clinical testing and nonconventional fuels credits. However, in contrast to the clinical testing and the nonconventional fuels credits, the research credit is provided up to a three-year carryback and a 15-year carryforward period if the research credit for a taxable year exceeds that year's tax liability limitation for research credit purposes.[1]

C. Business Credits

The last set of nonrefundable credits that are subject to limitation are the business credits.[2] Subparts D, E, and F provide for the following credits.

[1] Code §30(g) prior to amendment by the 1986 TRA.

[2] Subpart C of Part IV sets forth the following refundable credits that are not subject to limitation: the §31 wage withholding credit, the §32 earned income credit, the §33 nonresident alien, foreign corporation withholding credit, the §34 gasoline and special fuels credit, and the §35 tax overpayment credit.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Description	*Code Section*
General Business	§38
Alcohol Fuels	§40
ESOP	§41
Investment Credit Amount	§46
Investment Credit Recapture	§47
Investment Credit Definitions	§48
Targeted Jobs Credit Amount	§51
Targeted Jobs Credit Special Rules	§52

The general business credit of §38 is a composite of four separate credits — namely, the alcohol fuels credit, the ESOP credit, the investment credit, and the targeted jobs credit. The reason for grouping these credits under §38, the substantive rules for which are found in other Code provisions, is to provide a unified tax liability limitation and unified carryback and carryforward rules for the credits so grouped.

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

Under §38(c), the total business credit determined under §38(a) cannot exceed the sum of (i) the first $25,000 of the taxpayer's "net tax liability" for the taxable year, plus (ii) 85% of the taxpayer's "net tax liability" exceeding the first $25,000. The term "net tax liability" is defined by §38(c)(2) as tax liability within the meaning of §26(b) reduced by the sum of the nonrefundable personal credits, foreign tax credit, clinical testing credit, nonconventional fuels credit, and the research credit. Section 38(c) also sets forth special rules to split the $25,000 amount that the general business credit can fully offset between a husband and wife filing separate returns and to apportion the $25,000 amount among the component members of a controlled group of corporations.

Under §39(a)(1), an unused general business credit, to the extent it is attributable to the amount of the current year business credit, is carried back to each of the three taxable years preceding the unused credit year and is carried forward to each of the 15 taxable years following the unused credit year. The credit carryover is taken into account for a particular carryover year in the manner provided in §38(a).

D. Alternative Minimum Tax

The alternative minimum tax, which prior to its revision by the 1986 TRA applied only to noncorporate taxpayers, contains an additional limitation on the use of nonrefundable credits. Section 55(c)(1), as in effect before the enactment of the 1986 Act, precludes the application of the nonrefundable credits (other than the §27 foreign tax credit) against alternative minimum tax liability. To the extent that a credit that may be carried over for regular tax purposes, such as the research or general business credit, is disallowed because of the application of the alternative minimum tax, §55(c)(3) intends that the credit carryover be increased by the amount of the disallowed credit. However, after amendment by Tax Reform Act of 1984,[3] §55(c)(3) fails to achieve the desired result because of a technical drafting flaw. The 1984 version of §55(c)(3) provides that the amount of the carryover increase equals the tax liability limitation for the credit involved reduced by the amount of minimum tax. The tax liability limitation, however, may bear no relationship to the amount of the credit disallowed by the alternative minimum tax. In contrast, the pre-1984 §55(c)(3) provided that the increase in the amount of a credit carryover on account of the alternative minimum tax was computed by substituting for the tax liability limitation for a particular credit, the amount of the credit allowable against the regular tax, reduced (but not below zero) by the amount of the alternative minimum tax.

II. Outline of 1986 TRA Changes

The 1986 TRA makes the following changes to the substantive provisions of the credits:

Nonrefundable Personal Credits: The political contribution credit of §24 is repealed, effective for taxable years beginning after December 31, 1986.[4] In addition, miscellaneous changes were made to the mortgage certificate credit to conform that credit to changes made in the tax-exempt bond area. The mortgage credit certificate conforming changes are generally effective for certificates issued after August 15, 1986. Act §§1301(f)(2) and 1311(b)(2).

Miscellaneous Credits: The principal change to the miscellaneous credits is that the research credit is completely revised, redesignated as §41, and made part of the general business credit of §38. Act §231(d). The research credit revisions are generally effective for taxable years beginning after December 31, 1985. Act §231(g).

Business Credits: As mentioned, the research credit is made part of the general business credit of §38. In addition, a new credit, the low-income housing credit of new §42, is added as another component of the general business credit. Act §252(a). The low-income housing credit will generally apply to buildings placed in service after December 31, 1986. The 10% regular investment credit of §46 is generally terminated for property placed in service after December 31, 1985, as provided in §49. The rehabilitation credit, which is a component of the investment credit, is generally revised for property placed in service after December 31, 1986. Act §251(d). The targeted jobs credit is extended to apply to employees hired before 1989. Act §1701(a). Finally, the ESOP credit of §41 is repealed as to compensation paid or accrued after December 31, 1986. Act §1171.

The foregoing substantive changes are analyzed more completely in chapters 11, 12, 13, 16 and 17 of this portfolio.

[3] P.L. 98-369, §474(q).
[4] 1986 TRA, Act §§151 and 112.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

In the credit limitation area, the following changes have been made that will be considered in more depth herein:

General Business Credit: Effective for taxable years beginning after 1985, the 85% tax liability limitation in §38 has been reduced to a 75% limitation. Thus, after 1985, the general business credit can offset the first $25,000 of tax liability (after reduction by other nonrefundable credits) and 75% of any remaining liability in excess of the first $25,000. Act §221. In addition, because the research credit has been made a component of the general business credit for taxable years beginning after 1985, and because the low-income housing credit has been made a component as to property placed in service after 1986, these two credits will be subject to the tax liability limitation of §38 and carryover rules of §39.

Nonrecourse Financing Limitation: Because of the extension of the at-risk rules of §465 to real property, effective generally for property placed in service after 1986 (Act §§201(d)(7)(A) and 203), the nonrecourse financing limitation of §46(c)(8) will apply to the rehabilitation credit on rehabilitated property placed in service after 1986.

Passive Loss and Credit Limitation: For taxable years beginning after 1986, all business credits other than the foreign tax credit will be subject to the passive activity loss and credit limitations of §469.

Alternative Minimum Tax: Effective for taxable years beginning after 1986, the alternative minimum tax will be incorporated directly into each separate credit limitation and will apply to corporate as well as noncorporate taxpayers. In addition, in a retroactive technical correction,[5] the noncorporate limitation of §55(c)(3) in effect for taxable years beginning after 1983 has been amended to correct the technical flaw that could preclude the carryover of a nonrefundable business credit disallowed by reason of the alternative minimum tax.

III. Detailed Analysis

A. Consolidation of Credits into General Business Credit

1. Components of Credit

The 1986 TRA adds two credits to the roster of credits included under the §38 general business credit and strikes one credit from the roster. Effective generally for taxable years beginning after December 31, 1985, the 1986 TRA adds the research credit, which prior to 1986 was a miscellaneous credit contained in §30 of the Code, to the list of general business credits and redesignates it as the §41 credit.[6] Effective generally as to buildings placed in service after December 31, 1986, the 1986 TRA adds a new §42 low-income housing credit as a component of the §38 general business credit.[7]

Finally, the 1986 TRA repeals the ESOP credit of §41 and strikes the §41 credit from the list of credits included under the general business credit.[8] In general, the repeal of the §41 ESOP credit is effective as to compensation paid or accrued after December 31, 1986. Consequently, for 1986, there are two §41 credits listed under §38. The listing of the two credits for 1986 will have no practical significance to a corporate taxpayer that might qualify for both credits. Each credit amount should be determined under its own applicable §41 rules and the amounts so determined will be subject to the general §38(c) tax liability limitation in effect for 1986.

Accordingly, the list of credits included under §38 after the 1986 TRA will be as follows:

(i) The investment credit (including the rehabilitation credit) determined under §46(a);

(ii) The targeted jobs credit determined under §51(a);

(iii) The alcohol fuels credit determined under §40(a);

(iv) The ESOP credit determined under §41(a), which remains in effect as to compensation paid or accrued through December 31, 1986;

(v) The research credit determined under §41(a), effective generally for taxable years beginning after 1985; and

(vi) The low-income housing credit determined under §42(a), effective generally for buildings placed in service after 1986.

2. Tax Liability Limitation for 1986

Effective for taxable years beginning after December 31, 1985, the 1986 TRA[9] reduces the percentage tax liability limitation in §38(c) from 85 to 75%. Thus, as amended, the amount of the general business credit for a taxable year beginning after 1985 may not exceed the sum of (i) the first $25,000 of the taxpayer's net tax liability for the taxable year plus (ii) 75% of any net tax liability for the taxable year exceeding $25,000. The definition of "net tax liability" remains unchanged for 1986. However, both the §38(c) tax liability limitation and the §26 net tax liability definition are revised, principally to incorporate changes made under the alternative minimum tax rules taking effect for taxable years beginning after 1986. The alternative minimum tax revisions to the credit limitations are discussed in II, D, *infra*.

3. Credit Carryover

To reflect the addition of the research credit of §41 to the roster of general business credits, a new transitional rule is added in Code §39(d) to account for a research credit carryforward from 1985 to 1986 as well as to account for a business credit carryback to a year before 1986 in which a research credit was claimed. Act §231(d)(3)(C)(i). Section 39(d)(3) effectively requires that a research credit carryforward under §30(g) to a taxable year beginning after 1985 be combined with any other credits carried forward to the first post-1985 taxable year. The research and other business credits so combined are

[5] 1986 TRA, Act §1847(a)(1).
[6] 1986 TRA, Act §231.
[7] 1986 TRA, Act §252.
[8] 1986 TRA, Act §1171.
[9] 1986 TRA, Act §221.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

subject to the post-1985 general business credit limitation such as the 75% percentage limitation on tax liability exceeding $25,000. Section 39(d)(3) further requires that, if a general business credit is carried back to a taxable year beginning before 1986, it is treated as being used to offset tax liability only after the application of any research credit under §30(g) for the carryback year.

B. Nonrecourse Financing Limit

1. General

For taxable years beginning after December 31, 1986, a regular investment credit, to the extent still allowed under the investment credit termination rules of §49, and the rehabilitation credit, as revised by the 1986 TRA, will continue to be subject to the general business credit limitation of §38. Moreover, effective generally for property placed in service after 1986, the nonrecourse financing limit of §46(c)(8) is expanded to apply to investment and rehabilitation credits derived by certain taxpayers from real property. This is accomplished by the amendment of §465(c)(3) by the 1986 TRA [10] to eliminate for post-1986 taxable years the at-risk exception for the holding of real property. Since the nonrecourse financing limit of §46(c)(8) applies to the activities subject to the at-risk limits of §465 and since real property will no longer be an excepted activity, investment and rehabilitation credits derived from real property placed in service after 1986 by a taxpayer subject to the §465 rules must satisfy the §46(c)(8) requirements with respect to the financing on the property.

As a threshold matter, the §465 rules and, consequently, the §46(c)(8) requirements apply to individuals and closely held C corporations meeting the stock ownership requirements for a personal holding company.[11]

Thus, as to an individual or closely held C corporation, §46(c)(8) provides that the basis of property on which the investment and rehabilitation credit is determined is reduced by the amount of nonrecourse financing on the property. Nonrecourse financing includes any amount as to which the taxpayer is protected against loss — for example, guarantees or stop-loss agreements. Nonrecourse financing also includes amounts borrowed from a person who has an interest in the activity in which the property is used or from a person related to such person.

2. Qualified Commercial Financing Exception

An exception from the nonrecourse financing limit is made for "qualified commercial financing." [12] Qualified commercial financing includes nonrecourse financing provided or guaranteed by any federal, state, or local government, or borrowed from a qualified person. A qualified person includes any person actively or regularly engaged in the business of lending money but who is not any person who is related to the taxpayer, the person from whom the taxpayer acquired the property (or any person related to that person), or any person who receives a fee with respect to the taxpayer's investment in the property (or a person related to such person).[13] The qualified finance exception will not apply if the amount of the nonrecourse financing with respect to the property exceeds 80% of the taxpayer's basis in the property. In addition, the exception will not apply if the property was acquired by the taxpayer from a related person.

3. Partnerships and S Corporations

The determination of nonqualified, nonrecourse financing is made at the partner or shareholder level in the case of partnerships and S corporations.[14] If a qualified person provides recourse financing to an S corporation, an allocable share of such financing is treated as recourse to the S corporation's shareholder. Thus, even though the shareholder may not be personally liable for the S corporation's debts, the S corporation shareholder will be treated as liable as to the shareholder's allocable share of such financing. The S corporation's property qualifies for this exemption only if it is used by the S corporation in an active trade or business which has at least three full-time non-owner employees during the entire 12-month period ending on the last day of the taxable year, and if the services of such individuals are directly related to the business. A full-time employee must also be active in the management of the business. Because of these active business and employee requirements, it is unlikely that the S corporation recourse financing exemption will prove helpful in obtaining at the shareholder level an investment or rehabilitation credit derived from property that will be used by the S corporation for rental purposes.

The amount of any partner's or S corporation shareholder's allocable share of financing will be made in the same manner as the credit with respect to the property as allocated among the partners and shareholders.

4. Subsequent Years; Lessees

A subsequent decrease in nonqualified, nonrecourse financing may increase the amount of the investment and rehabilitation credit available to a taxpayer.[15] A subsequent increase in nonqualified, nonrecourse financing may, correspondingly, cause recapture of a credit previously claimed.[16]

Special at-risk coordination rules are provided for a regular or rehabilitation credit passed through to a lessee under §48(d).[17] In general, a lessee will be allowed a full credit only if the lessee is obliged to make rental payments that equal 30% of the present value of the amount for which the lessee is treated as having acquired the property by reason of the lessor's election. In addition, the lessee's credit is limited to the amount that would have been allowed to the lessor had the lessor's basis in the property been equal to the lessee acquisition amount, and the lessor had not made the pass-through election. Thus, the lessee

[10] 1986 TRA, Act §503.

[11] Under §542(a)(2), the stock ownership rules are met if five or fewer individuals hold more than 50% in value of the outstanding stock of the corporation at any time during the last half of the taxable year, applying attribution rules.

[12] §46(c)(8)(d)(ii).

[13] The definition of a related person is quite broad and includes any person related under §§267(b) or 707(b)(1), substituting a 10% ownership requirement for the 50% ownership provision in those rules, as well as any commonly controlled trades or business as defined in §52(a) and (b).

[14] §46(c)(8)(E).

[15] §46(c)(9).

[16] §47(d).

[17] §48(d)(6).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

will receive the full credit only if the lessor (who is subject to the at-risk rules) is at-risk with respect to the property.

C. *Passive Activity Limit*

1. *Overview*

The passive activity loss and credit rules are analyzed in considerable detail in Chapter 17 of this portfolio. However, because of their importance in the credit area, the rules will be reviewed here, particularly as they relate to credits.

Effective generally for taxable years beginning after December 31, 1986, the 1986 TRA [18] enacts new Code §469 to limit the "passive activity losses and credits" of certain taxpayers. In general, a "passive activity" is any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. The taxpayers to whom the §469 limitations will apply include individuals, estates, trusts, personal service corporations, and (to a lesser extent) other closely held C corporations. §469(a)(2).

If a loss or credit is derived from a passive activity by one of the foregoing taxpayers (other than closely held C corporations), the loss or credit will be limited to income generated from other passive activities. Any loss or credit not allowed by reason of the §469 limits will be available as a carryforward to future years and will generally be allowed when passive income is generated from the activity or from other passive activities or, in the case of losses, the activity is sold or otherwise disposed of.

2. *Definition of Passive Activity*

Post-TRA 1986 §469(c) defines a "passive activity" as any activity involving the conduct of any trade or business in which the taxpayer does not materially participate. A passive activity includes any rental activity, regardless of whether it constitutes a trade or business and regardless of the taxpayer's "material participation" in the activity. However, if the rental activity requires the provision of substantial services, such as a hotel, the activity is not treated as passive so long as the taxpayer materially participates. For purposes of the passive activity definition, a trade or business will include any activity involving research or experimentation within the meaning of §174 or, to the extent provided in regulations, any activity in connection with a trade or business or any §212 income-producing activity. §469(c)(5), (6).

Under §469(h), a taxpayer "materially participates" in an activity only if the taxpayer's involvement in the activity is regular, continuous, and substantial. In determining whether a taxpayer materially participates, the activities of a spouse will be attributed to the taxpayer. Moreover, a special rule permits a retired farmer or a surviving spouse of a farmer to be treated as a material participant if, prior to retirement or death, the farmer materially participated in the farming activity. A corporation subject to §469 is treated as materially participating if over 50% (by value) of the shareholders materially participate in the activity or if, in the case of a closely held C corporation (but not personal services corporation), the business is an active business meeting the requirements of §465(c)(7)(C)(i), (ii), and (iii).

Except as provided in regulations, a taxpayer is not treated as materially participating in a limited partnership to the extent of the taxpayer's interest as a limited partner.[19] For example, if a taxpayer holds a 25% general partnership interest and a 25% limited partnership interest in the same partnership and the taxpayer materially participates in the partnership's activities, the losses and credits allocable to the 25% limited partnership interest will be treated as passive. To prevent avoidance of the passive loss and credit limits, regulations may be issued to override the general rule that a limited partnership interest is treated as passive.

3. *Taxpayers Subject to Passive Limits*

Section 469(a)(2) provides that the following taxpayers may be subject to the passive loss and credit limits:

(i) Any individual, estate, or trust,

(ii) Any closely held C corporation, and

(iii) Any personal service corporation.

However, under §469(e)(2), the passive loss and credit limits are less restrictively applied to closely held C corporations than to the other categories of taxpayers subject to the rule.

Section 469(j)(1) defines a "closely held C corporation" as any C corporation where, at any time during the last half of the taxable year, more than 50% in value of the outstanding stock is owned by no more than five individuals (applying the personal holding company attribution rules). A "personal service corporation" is defined under §469(j)(2) as a corporation whose principal activity is the performance of personal services that are substantially performed by employee-owners. However, a corporation will not be treated as a personal service corporation unless more than 10% of the stock by value is held by employee-owners.

4. *Definition of Passive Loss and Credit*

The passive activity loss for a taxable year is determined by netting the aggregate income and losses from all passive activities. If the aggregate losses exceed the aggregate income, the resulting net loss is the taxpayer's "passive activity loss." [20] According to the Conference Report,[21] all deductions arising from passive activities, including deductions allowed under §§162, 163, 164, and 165, must be taken into account, even if claimed as itemized deductions on the taxpayer's return. Interest deductions attributable to passive activities are treated as passive activity deductions and will not be treated as investment interest subject to the revised investment interest limits of §163(d).

Section 469(d)(2) defines a "passive activity credit" as the amount, if any, by which the sum of various business credits derived from passive activities exceeds the taxpayer's regular tax liability for the taxable year allocable to

[18] 1986 TRA, Act §501(a), (c).

[19] §469(h)(2).

[20] §469(d)(1).

[21] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-139 (1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

passive activities. Because of this definition, which looks to "regular tax liability . . . allocable to all passive activities," a passive activity credit will not be allowable under §469 unless passive activity income for the year exceeds passive losses and thereby generates "regular tax liability."

The credits subject to limitation as passive activity credits are as follows:

(i) The §936 possessions credit;

(ii) The clinical testing credit;

(iii) The nonconventional fuels credit; and

(iv) The general business credit which, after 1986, will include the regular credit to the extent still allowed by the §49 termination rules, the rehabilitation credit, the energy investment credit, the research credit, the alcohol fuels credit, the targeted jobs credit, and the new low-income housing credit.

Under §469(e), (i) portfolio income (interest, dividends, annuities, royalties, and investment gains), (ii) expenses other than interest that are clearly and directly allocable to portfolio income, and (iii) interest expense properly allocable to portfolio income are not taken into account in determining the income or loss from an activity. For this purpose, however, an interest in the passive activity is not treated as investment property so that gains and losses upon disposition of a passive activity interest will be taken into account in determining passive activity income and loss. Investment earnings on an activity's working capital will be treated as portfolio income for purposes of the foregoing rule.

Earned income will not be treated as passive income for purposes of the passive limits. §469(e)(3).

5. Exceptions

Section 469(e)(2) permits the passive losses and credits of a closely held C corporation, other than a personal service corporation, to offset "net active income" — income without regard to passive activity income or loss and portfolio income or loss.

Section 469(i) provides a limited exception for individuals who actively participate in real estate activities. Under this exception, up to $25,000 of passive losses (or the amount of credit that is the deduction equivalent of the passive loss) may be used to offset nonpassive income. However, this $25,000 amount is phased out if the taxpayer's adjusted gross income (AGI), excluding passive losses, exceeds $100,000. For every $2 of AGI above $100,000, the $25,000 amount is reduced by $1. Thus, the exception vanishes if AGI exceeds $150,000.

The $25,000 amount is available generally only if the taxpayer is an "active participant" in the rental activity. A taxpayer will not be treated as an active participant if, at any time during the taxable year, the taxpayer's interest in the activity is less than 10% by value of all interest in the activity. §469(i)(6). Moreover, a taxpayer's interest as a limited partner will not be treated as an interest with respect to which the taxpayer actively participates. §469(i)(6)(C).

Two special rules apply to the rehabilitation and low income housing credits. First, the $25,000 amount (in a deduction-equivalent sense) is available regardless of active participation by the taxpayer. §469(i)(6)(B). Second, under §469(i)(3)(B), the threshold for the phase-out of the $25,000 amount is raised to $200,000.

Section 469(j)(5) defines the term "deduction equivalent" as an amount which, if allowed as a deduction, would reduce the regular tax liability for the taxable year by an amount equal to such credits. Assuming a taxpayer's taxable income is entirely subject to tax at the 28% rate and the taxpayer has no itemized deductions dependent upon the amount of the taxpayer's AGI, the deduction equivalent of credits equal to the $25,000 amount is $7,000.

6. Suspended Passive Losses and Credits

Losses and credits not allowed under §469 are suspended until such time as the taxpayer generates passive income from the passive activity or has income from unrelated passive activities. Under §469(g), if a taxpayer disposes of his entire interest in any passive activity in a fully taxable transaction, any suspended loss as well as any loss arising in the year of disposition will be allowable as follows:

(i) First, against income or gain from the passive activity for the taxable year including any gain recognized on the disposition;

(ii) Second, against net income or gain for the taxable year from other passive activities; and

(iii) Finally, all other income or gain.

A capital loss from the disposition of the passive activity will, however, be subject to the §1211 capital loss limitations. §469(g)(1)(C). Moreover, under §469(g)(1)(B), losses will continue to be suspended if the taxpayer transfers the interest to a related person described in §§267(b) or 707(b)(1). If the interest is sold in a §453 installment sale, a ratable share of the suspended losses will be allowed each year in accordance with the amount of the installment sale gain reported for that year for regular tax purposes. §469(g)(3).

If an interest in a passive activity is transferred by reason of the taxpayer's death, suspended losses will be allowed on the taxpayer's final return to the extent that the losses exceed the step-up in basis (to fair market value) that occurs under §1014 upon death. §469(g)(2). Any excess shall not be allowed as a deduction for any taxable year.

Under §469(j)(6), if an interest in a passive activity is transferred by gift, the basis of the interest will be increased by the amount of the suspended losses and such losses will no longer be allowable as a deduction for any taxable year.

Section 469(j)(9) allows a taxpayer, upon a fully taxable disposition of a passive interest, to elect to increase his basis in the passive activity by the amount of any unused credit which reduced the basis of the property for the taxable year in which the credit arose. The basis increase is made as of the time immediately before the transfer. If this election is made, the passive activity credit will not be allowed in the future. If the election is not made and if the

 ©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

transfer does not otherwise cause recapture of the credit, the suspended credit will be allowed to offset the regular tax from the gain, if any, generated on the transfer or to offset the regular tax from passive income subsequently generated from other activities.

Under §469(f), if an activity ceases to be a passive activity, suspended passive losses and credits will be allowed as an offset against future income and future regular tax liability from active operations. Otherwise, the suspended deductions and credits continue to be treated as arising from a passive activity (*i.e.*, they may be used to offset income from other passive activities). Similar principles apply to a change in status of a closely held C corporation or personal service corporation. §469(f)(2).

7. Effective Dates and Phase-In Rules

The passive loss and credit limits apply generally to taxable years beginning after December 31, 1986. Act §501(c)(1). However, loss and credit carryovers from a taxable year beginning before 1987 and carried to a taxable year beginning after 1986 are not subject to the limits. Act §501(c)(2). Moreover, special transition rules apply to low-income housing.[22]

Under §469(l), the passive loss and credit limits are phased in over four years if (i) the taxpayer held the interest in the passive activity, or was under a binding contract to acquire the interest in the passive activity, on the date of enactment (October 22, 1986) and at all times thereafter, and (ii) the passive activity was being conducted on October 22, 1986, or the property used in the activity is acquired pursuant to a binding written contract in effect on August 16, 1986, or construction of the property began on or before August 16, 1986.

A binding contract qualifies under this rule, even if the taxpayer's obligation to acquire an interest is subject to contingencies, so long as the contingencies are beyond the reasonable control of the taxpayer. Under the phase-in, 65% of a passive activity loss and credit will be allowed for taxable years beginning in 1987. This allowance percentage is reduced over the ensuing three taxable years as follows: 40% for 1988, 20% for 1989, and 10% for 1990. The balance not allowed is suspended and may not be taken into account in computing the amount allowable under the phase-in in a subsequent year during the phase-in period.

It is important to note that, in computing taxable income under the revised alternative minimum tax taking effect for post-1986 taxable years, §58(b) requires full suspension of a passive activity loss without regard to the §469(l) phase-in. For example, if a taxpayer has a $100,000 passive loss for 1987 attributable entirely to straight-line ACRS real property depreciation on a rental property, $65,000 of the loss may be deducted for regular tax purposes under the phase-in but no amount is allowable as a deduction for minimum tax purposes. However, §53 will provide a minimum tax credit to the extent that a minimum tax must be paid as a result of the lack of the phase-in for minimum tax purposes. The minimum tax credit is carried forward and may be applied against regular tax liability in ensuing years.

[22] *See* Act §501(c)(3) and Act §502.

D. Post-1986 Tax Liability Limitation: Alternative Minimum Tax

1. Nonrefundable Personal Credits

Effective for taxable years beginning after 1986, TRA 1986 [23] amends the tax liability limitations for nonrefundable personal credits, miscellaneous credits, and the general business credit to make the alternative minimum tax a direct limitation on a taxpayer's ability to offset tax liability for a taxable year by such credits. Since, commencing in 1987, corporate as well as noncorporate taxpayers will be subject to the revised alternative minimum tax, the alternative minimum tax limitation will apply to corporations for the first time.

Accordingly, the tax liability limitation for nonrefundable personal credits is revised to provide that the sum of such credits may not exceed the excess, if any, of the taxpayer's regular tax liability for the taxable year over the taxpayer's tentative minimum tax for that year, determined without regard to the alternative minimum foreign tax credit.[24] A taxpayer's "regular tax liability" is the income tax imposed on the taxpayer for the taxable year, reduced by the following 10 penalty-type taxes:[25]

(i) The alternative minimum tax of §55,

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

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

(iv) The accumulated earnings tax of §531,

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

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

(vii) The §1374 tax on certain built-in gains of S corporations,

(viii) The §1375 tax imposed on S corporations having passive investment income and subchapter C earnings and profits,

(ix) The tax imposed by §7518(g)(6)(A) on nonqualified withdrawals from capital construction funds, and

(x) The §§871(a) and 881 taxes on certain income of nonresident aliens and foreign corporations.

The taxpayer's "tentative minimum tax" is the taxpayer's alternative minimum tax liability for the taxable year, unreduced by the taxpayer's regular tax for the taxable year; *i.e.*, the tax determined by multiplying the taxpayer's alternative minimum taxable income reduced by the minimum tax exemption amount multiplied by the applicable minimum rate, which is 20% for corporations and 21% for noncorporate taxpayers.[26]

[23] 1986 TRA, §701(c).
[24] §26(a), as amended by 1986 TRA, Act §701(c)(1).
[25] §26(b), as amended by Act §701(c)(1).
[26] §55(b), as added by the 1986 TRA, Act §701(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

2. Miscellaneous Credits

The tax liability limitations on the two remaining miscellaneous credits — the clinical testing credit and the nonconventional fuels credit — are also amended to incorporate the alternative minimum tax as a direct limitation on the use of the credits. Each respective limitation [27] provides that the credit may not exceed the excess, if any, of the regular tax (reduced by the sum of the nonrefundable personal credits) over the tentative minimum tax for the taxable year.

3. General Business Credit

The limitation on the general business credit is similarly amended to incorporate directly the alternative minimum tax. As revised by TRA 1986 for taxable years beginning after December 31, 1986,[28] §38(c) provides that the general business credit allowed by §38(a) for any taxable year shall not exceed the lesser of (i) the allowable portion of the taxpayer's net regular tax liability for the taxable year, or (ii) the excess, if any, of the taxpayer's net regular tax liability for the taxable year over the tentative minimum tax for the taxable year.[29] The allowable portion of the taxpayer's net regular tax liability is equal to the first $25,000 of net regular tax liability plus 75% of the net regular tax liability for the year that exceeds $25,000.[30] Finally, the taxpayer's "net regular tax liability" is the taxpayer's regular tax liability reduced by the nonrefundable personal credits and the miscellaneous credits.[31]

An additional change made in the §38(c) general business credit limitation by the alternative minimum tax provisions is to permit C corporations to use the regular 10% investment credit to offset up to 25% of the corporation's alternative minimum tax liability. Act §701(c)(4), amending Code §382(c)(3). Post-TRA §38(c)(3) [32] provides that a C corporation may use its general business credit, to the extent the credit is attributable to the regular investment credit allowed under §46, against the greater of:

(i) the lesser of (a) the allowable portion of the taxpayer's net regular tax liability for the taxable year, or (b) the excess, if any, of the taxpayer's net regular tax liability for the taxable year over 75% of the tentative minimum tax for the taxable year, or

(ii) 25% of the taxpayer's tentative minimum tax for the year.

However, §38(c)(3) further provides that in no event should a credit be allowed which, in combination with the alternative tax net operating loss deduction and the alternative minimum tax foreign credit, would reduce the alternative minimum tax below an amount equal to 10% of the amount that would be determined as the alternative minimum tax without regard to the alternative tax net operating loss deduction and the alternative minimum tax foreign tax credit.

The net effect of this last limitation is to require that a corporation pay some alternative minimum tax for any given taxable year. In any case, the benefit that a corporation will derive from the allowance of the regular investment credit against the alternative minimum tax will be limited because §49 generally terminates the regular investment credit for property placed in service after 1985. Only to the extent that the regular investment credit is allowed under the §49(b) transition rules or to the extent that the regular investment credit is available as a carryforward from a preceding taxable year will the §38(c)(3) allowance provision come into play.

For all noncorporate taxpayers and for virtually all corporate taxpayers, the alternative minimum tax will be the principal limitation on the use of the general business credit, particularly after 1987 when the rate differential between the minimum tax and maximum regular tax rate for individuals is only 7 percentage points and the corporate regular and minimum tax rate differential is only 14 percentage points.

For example, assume an individual's taxable income and alternative minimum taxable income for 1988 is $500,000 and that the individual has a $200,000 rehabilitation credit for 1988. The taxpayer's regular tax due to the phasing out of the 15% lower bracket rate and personal exemptions will be an approximately 28% flat tax on the $500,000, or $140,000. Under the regular tax limitation of §38(c), the taxpayer's regular tax liability limitation is equal to the first $25,000 of this $140,000 tax plus 75% of the $115,000 balance, which equals $86,250; thus, the total regular tax liability limitation is $111,250. However, the taxpayer's tentative minimum tax on the $500,000 of alternative minimal taxable income is $105,000. Thus, the maximum amount of rehabilitation credit that the taxpayer may apply against his regular tax is $35,000 ($140,000 regular tax minus $105,000 tentative minimum tax).

[27] §§28(d)(2) and 29(b)(5), as amended by 1986 TRA, Act §701(c)(2) and (3).
[28] 1986 TRA, Act §701(c)(4).
[29] §38(c)(2).
[30] §38(c)(2).
[31] §38(c).
[32] As added by 1986 TRA, Act §701(c)(4).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 16

EXTENSION OF AT-RISK RULES TO REAL ESTATE

James F. Miller, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

Code §465 limits, in the case of certain taxpayers engaged in certain activities specified in §465, the allowance of any loss from such activities to the amount with respect to which the taxpayer is at risk for the activity at the close of the taxable year. The §465 at-risk rules were added to the Code by the Tax Reform Act of 1976 [1] and later modified by the Revenue Act of 1978.[2]

Under the at-risk rules, a taxpayer's deductible losses from an activity for any taxable year are limited to the amount the taxpayer could actually lose in the activity (*i.e.*, the amount for which the taxpayer is at risk). The initial amount at risk is generally the sum of: (1) the taxpayer's cash contributions to the activity; (2) the adjusted basis of other property contributed by the taxpayer to the activity; and (3) amounts borrowed for use in the activity with respect to which the taxpayer is personally liable, or has pledged as security for repayment property not used in the activity. §465(b)(1) and (2). This amount is generally increased each year by the taxpayer's share of income, and is decreased by the taxpayer's share of losses and withdrawals from the activity.

A taxpayer is generally not considered at risk with respect to borrowed amounts if: (1) the taxpayer is not personally liable for repayment of the debt (nonrecourse loans); or (2) the lender has an interest (other than as a creditor) in the activity (except to the extent allowed in regulations). §465(b)(3). The taxpayer is also not considered at risk with respect to amounts for which the taxpayer is protected against loss by guarantees, stop-loss arrangements, insurance (other than casualty insurance), or similar arrangements. §465(b)(4). Losses which may not be deducted for any taxable year because of the at-risk rule may be deducted in the first succeeding year in which the rule does not prevent the deduction. §465(a)(2).

Before the Tax Reform Act of 1986 (the "Act"), §465, with limited exceptions, applied to all activities except the holding of real property other than mineral property. Due to this exclusion, individuals investing in real estate could offset current taxable income from other sources (*e.g.*, wages) with tax losses that would never be matched by economic losses. The allowance of such non-economic losses for tax purposes was a necessary basis for many tax-sheltered real estate investments. The deferral of tax liability guaranteed a return to the investor that often made an otherwise non-economic investment possible.

The Reagan Administration became concerned that such tax-driven non-economic investment activity was diverting capital from more productive uses and was causing over-investment in real estate, thus distorting prices and capital costs throughout the economy.[3] It proposed, therefore, a broad application of the at-risk rules to real estate.

Congress, on the other hand, perhaps in the belief that other proposals (such as, for example, limitations on passive losses and investment interest) were sufficient in themselves to alleviate concerns about sheltering income with artificial losses, focused on the fact that limited-risk financing was being used to artificially inflate value and, thus, recoverable basis in property acquired by purchase. Thus, to "limit the opportunity for overvaluation of property (resulting in inflated deductions), and to prevent the transfer of tax benefits arising from real estate activities to taxpayers with little or no real equity in the property," Congress extended the present law at-risk rules to real estate, with an exception for certain nonrecourse financing provided by organizations in the business of lending.[4]

II. Overview

Section 503 of the TRA 1986 extends the §465 at-risk rules to the activity of holding real property, with an exception for taxpayers engaged in the activity of holding real property who will be considered at risk with respect to their share of any "qualified nonrecourse financing" which is secured by real property used in such activity.

The extension of the at-risk rules to the activity of holding real property is effective for property placed in service after December 31, 1986, and for losses attributable to an interest in a partnership or S corporation or other pass-through entity that is acquired after December 31, 1986.

[1] P.L. 94-455.
[2] P.L. 95-600.
[3] *See* The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985), at 326-327.
[4] S. Rep. No. 313, 99th Cong., 2d Sess. 748 (1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

III. Detailed Analysis

A. Qualified Nonrecourse Financing

Under new §465(b)(6)(B), the term "qualified nonrecourse financing" means any financing (i) which is borrowed by the taxpayer with respect to the activity of holding real property, (ii) which is borrowed by the taxpayer from a "qualified person" or represents a loan from any Federal, state, or local government or instrumentality thereof, or is guaranteed by any Federal, state, or local government, (iii) except to the extent provided in regulations, with respect to which no person is personally liable for repayment,[5] and (iv) which is not convertible debt.

Code §465(b)(6)(D)(i) provides that a "qualified person" has the meaning given such term by §46(c)(8)(D)(iv) which states that a "qualified person" means any person which is actively and regularly engaged in the business of lending money [6] and which is not —

(i) a related person with respect to the taxpayer,

(ii) a person from which the taxpayer acquired the property (or a related person to such person), or

(iii) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).[7]

Code §465(b)(6)(D)(ii) provides that §46(c)(8)(D)(iv) will be applied without regard to subclause (I), if the financing from the related person is "commercially reasonable and on substantially the same terms as loans involving unrelated persons." [8]

In the Conference Report to the 1986 TRA, the conferees state that it is their intention that terms of nonrecourse financing will be considered "commercially reasonable" if "the financing is a written unconditional promise to pay on demand or on a specified date or dates a sum or sums certain in money, and the interest rate is a reasonable market rate of interest (taking into account the maturity of the obligation)." [9]

The Senate Report states that under this rule, "real estate joint ventures may obtain financing from an otherwise qualified lender who has an equity interest in the venture, provided the lender is not the seller or related to the seller. Seller financing, of course, cannot qualify under this rule. The rule is not intended to facilitate the transfer of tax benefits or the overvaluation of property (and inflation of deductions). In addition, as is generally the case under the at risk rules, the financing must actually be debt and not disguised equity." [10]

The rationale for this rule is simple: seller financing is not treated as an amount at risk because there may be little or no incentive to limit the amount of such financing to the value of the property. In the case of commercial financing secured solely by the real property, however, the lender is less likely to make loans which exceed the property's value or which cannot be serviced by the property. This is so even when the lender is a joint venturer with the borrower.

B. Special Rule for Partnerships

Code §465(b)(6)(C) states that "[i]n the case of a partnership, a partner's share of any qualified nonrecourse financing of such partnership shall be determined on the basis of the partner's share of liabilities of such partnership incurred in connection with such financing (within the meaning of §752)." Thus, a partnership's nonrecourse financing may increase a partner's (including a limited partner's) amount at risk provided the financing is qualified nonrecourse financing for both the partner and the partnership. For purposes of determining whether partnership borrowings are treated as qualified nonrecourse financing with respect to the partnership, the partnership is treated as the taxpayer. For the purpose of determining whether a share of partnership borrowings is treated as qualified nonrecourse financing with respect to a partner, the partner is also treated as the borrower. The amount with respect to which the partners are treated as at risk cannot be more than the total amount of the qualified nonrecourse financing at the partnership level.[11]

C. Activity of Holding Real Property

Section 503(a) of the 1986 TRA repealed §465(c)(3)(D) which excluded from the application of §465(a) "the holding of real property (other than mineral property)" and "personal property and services which are incidental to making real property available as living accommodations." This latter phrase was intended to exclude from the at-risk rules the operation of a hotel, motel, or a furnished apartment.[12] Code §465(b)(6)(E), as added the by 1986 Act, clarifies that, as a general rule, to the extent an activity was not subject to the at-risk rules under former §465(c)(3)(D), it will be treated under current law as the activity of holding real property, which includes the provision of services and the holding of personal property which is merely incidental to the activity of making real property available as living accommodations. Note that the holding of mineral property does not constitute an activity of holding real property.

---

[5] The Senate Report states in this regard that "[r]egulations may set forth the circumstances in which guarantees, indemnities, or personal liability (or the like) of a person other than the taxpayer will not cause the financing to be treated as other than qualified nonrecourse financing." S. Rep. at 749.

[6] The Senate Report notes that such persons generally would include "a bank, savings and loan association, credit union, or insurance company regulated under Federal, State, or local law, or a pension trust." S. Rep. at 749.

[7] Thus, for example, seller financing and promoter financing are not qualified nonrecourse financing.

[8] The Senate Report notes that the Act adopts the definition of related person applicable under the investment tax credit at-risk rules. Under this rule, related persons generally include family members, fiduciaries, and corporations or partnerships in which a person has at least a 10% interest. S. Rep. at 749-750.

[9] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-135.

[10] S. Rep. at 749 (footnote omitted). In accordance with this pronouncement, the Finance Committee stated, in a footnote, its intention that the Treasury Department examine §704 and §752 "in light of the exception from the at-risk rules for nonrecourse loans made by qualified institutional lenders that are also partners (or related to partners), and in light of changes made by the Deficit Reduction Act of 1984."

[11] S. Rep. at 750.

[12] H.R. Rep. No. 1445, 95th Cong., 2d Sess. 70 (1978).

IV. Implications

Although many typical nonrecourse financing techniques qualify as at-risk amounts under the above rules, several common financing arrangements do not. Perhaps the most important of the newly nonqualified techniques is seller financing. The prohibition on seller financing can create problems where debt obligations on distressed properties are being restructured (*e.g.*, in workout situations). Lenders frequently acquire title to the property (*e.g.*, by foreclosure) in these situations before transferring it to a new owner. That chain of events would cause the loan to become "seller" financing, even if the original loan was for cash and the new owner assumes the old debt. On the other hand, the seller financing taint can be avoided if the property is transferred directly from the prior owner to the new owner. In this regard, lenders and buyers must be alert to the significance of the form as well as the substance of their transactions.

For loans to partnerships, qualification of a loan must be tested at the partnership level. The individual partner's share of the nonrecourse debt is determined based on the partnership rules generally applicable to the allocation of partnership liabilities. A loan disqualified at the partnership level does not provide an at-risk amount to any of the partners.

Finally, the Senate Report states that if a qualified nonrecourse financing is assumed or if property is taken subject to a nonrecourse debt which constituted qualified nonrecourse financing in the hands of the original borrower, such debt may be considered as qualified nonrecourse financing as to the transferee only if both the loan and the lender qualification requirements continue to be met with respect to the new borrower.[13] It is not clear how this rule applies to wraparound financing (wherein the original loan remains in place and the incremental debt "wraps around" the original loan). Presumably, the qualification of the overall wrap loan would determine whether any part of the debt is an at-risk amount.

[13] S. Rep. at 750. The Senate Report also notes that "[t]he same rule applies to subsequent transfers of the property taken subject to the debt, and to the admission of new partners to a partnership (or sale or exchange of partnership interest), so long as the debt constitutes qualified nonrecourse financing with respect to each transferee or new partner."

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 17

LIMITATIONS ON LOSSES AND CREDITS FROM PASSIVE ACTIVITIES

James F. Miller, Esq.
Silverstein and Mullens
Washington, D.C.

I. Overview

Prior to the enactment of the TRA 1986, no limitations generally were placed on the ability of a taxpayer to use deductions from a particular activity to offset (*i.e.*, shelter) income from other activities. Similarly, most tax credits could be used to offset tax attributable to income from any of the taxpayer's activities. Both the Reagan Administration and Congress became concerned that extensive shelter activity was contributing to public concerns that the tax system is unfair, and to the belief that tax is paid only by the naive and unsophisticated.[1] The Congressional response to these concerns was to adopt, in §501 of the TRA 1986, a set of rules which directed the benefit of tax preference items "primarily to taxpayers with a substantial and *bona fide* involvement in the activities to which the preferences relate." [2] These rules, set forth in new §469, strictly limit the ability of individuals (including partners and S corporation shareholders), trusts, estates, closely held C corporations and personal service corporations [3] to use losses (both noncash or "paper" losses, such as depreciation and accrued expenses, and out-of-pocket or "real" losses) and credits from "passive activities" to shelter their income from "nonpassive" sources.

For purposes of the new passive loss and credit limitation rules, a "passive activity" includes any activity involving the conduct of a trade or business in which the taxpayer does not "materially participate." §469(c). Congress believed it appropriate to examine the materiality of a taxpayer's participation in an activity because "[a] taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant nontax economic profit motive, and to form a sound judgment as to whether the activity has genuine economic significance and value.[4] However, Congress felt that the material participation standard was "not wholly adequate" to rental activities, because rental activities "generally require less ongoing management activity, in proportion to capital invested, than business activities involving the production or sale of goods and services." [5] Because, in its determination, "[t]he extensive use of rental activities for tax shelter purposes under pre-1986 TRA law, combined with the reduced level of personal involvement necessary to conduct such activities, make clear that the effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities," Congress made rental activities passive *per se* for purposes of the loss limitation rules.[6]

Congress thought, however, it would be appropriate to provide "[a] limited measure of relief * * * in the case of certain moderate-income investors in rental real estate, who otherwise might experience cash flow difficulties with respect to investments that in many cases are designed to provide financial security, rather than to shelter a substantial amount of other income." [7] Accordingly, it permitted "natural persons" to offset up to $25,000 of nonpassive income (*e.g.*, salary or active business income) by using losses from rental real estate activities with respect to which the individuals "actively participate." [8] This allowance, examined in more detail below, is phased out ratably as the taxpayer's adjusted gross income (determined without regard to deductible IRA contributions, taxable social security benefits and any passive activity loss) increases from $100,000 to $150,000 (or $200,000 to $250,000, in the case of certain credits).

Congress further determined that because (1) because limited partnerships "commonly are used as vehicles for marketing tax benefits to investors seeking to shelter unrelated income," and (2) a limited partner "generally is precluded from materially participating in the business activity of the partnership," a taxpayer's participation in an activity as a limited partner should not be considered "material," except as provided in regulations.[9]

Finally, because the oil and gas industry currently "is suffering severe hardship due to the worldwide collapse of oil prices," and because it felt that "financial risk" is a

[1] S. Rep. No. 313, 99th Cong., 2d Sess. 714 (1986)(hereafter "Senate Report"). All references to the Code are to the Internal Revenue Code of 1986, unless otherwise specified.
[2] *Id.*, at 716.
[3] §469(a)(2).
[4] Senate Report at 716.
[5] Senate Report at 718.
[6] *Id.*
[7] *Id.*
[8] §469(i).
[9] §469(h)(2); Senate Report at 718.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

more "relevant" standard to oil and gas activities than material participation, Congress created a measure of relief for taxpayers who "are willing to accept an unlimited and unprotected financial risk proportionate to their ownership interests in oil and gas activities." [10] Accordingly, for purposes of the passive loss rules, the term "passive activity" does not include a "working interest" in "any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest." [11]

As a general rule, deductions or credits from passive activities, to the extent they exceed income from all such passive activities may not be applied against nonpassive income or tax attributable to such nonpassive income. Such "suspended" losses and credits must be carried forward and treated as deductions and credits from passive trade or business activities in future years. §469(b). Suspended losses from an activity are allowed in full only when the taxpayer disposes of his entire interest in the activity in a fully taxable transaction. §469(g). Congress believed it "appropriate to treat losses of the activity as not realized by the investor prior to disposition of his interest in the activity," because "[t]he effort to measure, on an annual basis, real economic losses from passive activities gives rise to distortions, particularly due to the nontaxation of unrealized appreciation and the mismatching of tax deductions and related economic income that may occur, especially where debt financing is used heavily." [12] Congress felt that "[o]nly when a taxpayer disposes of his interest in an activity is it possible to determine whether a loss was sustained over the entire time that he held the interest." [13]

The new rules limiting the application of passive losses and credits raise many important issues. The following discussion outlines these rules in detail and identifies certain problem areas not addressed in the statute or Committee Reports.

II. Detailed Analysis

A. Passive Activity

Code §469(c)(1) defines a "passive activity" as any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate. The term "passive activity" includes any "rental activity," [14] but does not include any working interest in oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to the interest.[15] For purposes of §469(c)(1)(A), the term "trade or business" includes (1) activities generating deductions allowable under §174 as research and experimentation expenditures,[16] and (2) to the extent provided in regulations, an activity conducted for profit (within the meaning of §212), including an activity that is not a trade or business.[17] In this regard, the Conference Report anticipates "that the exercise of this [regulatory] authority may be appropriate in certain situations where activities other than the production of portfolio income are involved. This regulatory authority is meant to cause the passive loss rule to apply with respect to activities that give rise to passive losses intended to be limited under this provision, but that may not rise to the level of a trade or business." [18]

Under §469(h)(1), a taxpayer will be treated as materially participating in an activity only if the individual is involved in the operations of the activity on a regular, continuous, and substantial basis. Under §469(h)(2), except as provided in regulations, no interest in a limited partnership as a limited partner will be treated as an interest with respect to which a taxpayer materially participates. The material participation standard is inapplicable to rental activities and working interests in oil and gas properties.[19]

1. Definition of Activity

In applying the passive loss rule, one of the most important determinations that must be made generally is the scope of a particular activity. The determination is important for several reasons. For example, defining an activity too broadly would permit taxpayers to amalgamate undertakings that are in fact separate. By aggregating separate undertakings, a taxpayer could shelter income from a nonpassive activity with losses and credits from a passive activity. Defining activities too narrowly, however, could prevent taxpayers from offsetting losses from one or more passive activities against profits from other passive activities. On the other hand, defining activities too narrowly could enable taxpayers to trigger suspended losses upon what is, in fact, a partial disposition.

The Senate Report states that the determination of what constitutes a separate activity is intended to be made in a "realistic economic sense." [20] The question to be answered is "what undertakings consist of an integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss." [21]

Applying the "economic interrelationship" rules to farming and rental activities is likely to be fairly simple. Generally, each farm and each rental project will be a separate activity. Similarly, it is possible that each location in a retail or service operation might also be a separate activity. Beyond that, the facts and circumstances must be carefully considered.

In the case of affiliated groups of corporations filing consolidated returns, the rules are applied on a consolidated basis. The separate activities of the group are identified without regard to entity boundaries within the group. Thus, an activity may be conducted by several corporations, and

[10] Senate Report at 717-18.
[11] §469(c)(3)(A).
[12] Senate Report at 716-17.
[13] *Id.*
[14] §469(c)(2).
[15] §469(c)(3)(A).
[16] §469(c)(5).
[17] §469(c)(6).
[18] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-138 (1986) (hereafter "Conference Report").
[19] §469(c)(4).
[20] Senate Report at 739.
[21] *Id.* Presumably, the Treasury will consider these factors when prescribing regulations specifying what constitutes an "activity" for §469 purposes pursuant to its mandate set forth in §469(k)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

conversely, one corporation may be engaged in several activities.[22]

Note: The Conference Report, at II-140, observes that the passive activity rules apply to corporations filing consolidated returns on a consolidated group basis in the following instances:

(i) In applying the special rule that passive losses may not offset the portfolio income of closely held corporations;

(ii) In determining whether the corporations in the group materially participate in an activity; and

(iii) In determining whether a member of the group is a personal service corporation.

The Conference Report states that, as an example, a corporation may be treated as a personal service corporation where the owners performing the requisite services are employed by a subsidiary of the parent corporation.

The question of what constitutes a separate activity has diminished relevance, however, where a limited partnership participates in several undertakings. Under the statute, no interest in a limited partnership as a limited partner is treated as an interest with respect to which the taxpayer materially participates, regardless of the nature and extent of the partnership's undertakings and the limited partners' roles in the undertakings.[23] Thus, if but for their participation as limited partners, taxpayers would be considered as materially participating in one or more of several undertakings of a limited partnership, it becomes imperative under the Bill for such taxpayers to engage in such undertakings through a general partnership or S corporation.

The special treatment of limited partnership interests might lead to attempts to attribute activities to a limited partnership interest that are clearly not passive (such as personal services) so as to shelter the income from such activities. The Senate Report makes it clear that "any undertaking that is accorded special treatment under the passive loss rule * * * is not treated as part of the same activity as any undertaking that does not receive identical treatment under the passive loss rule." [24]

Similarly, income received by an individual from the performance of personal services with respect to a passive activity is not treated as income from a passive activity.[25] Thus, for example, in the case of a limited partner who is paid for performing services for the partnership (whether by way of salary or guaranteed payment), such payments cannot be sheltered by any passive losses.

Unexpected results can follow. Assume the sole shareholder of an S corporation engaged in a passive activity receives a salary of $5,000 for services and that the deduction at the corporate level will result in a $5,000 tax loss. The shareholder will have $5,000 in earned income and a $5,000 passive activity loss passed through from the S corporation. The passive loss, therefore, cannot be used to offset the income.

[22] Conference Report at II-140.
[23] §469(h)(2).
[24] Senate Report at 741.
[25] §469(e)(3).

2. Material Participation

a. Involvement in Operations on a Regular, Continuous, and Substantial Basis

Outside of the limited partnership context (discussed below), the presence or absence of material participation in an activity generally must be determined with reference to all the facts and circumstances. In determining whether a taxpayer materially participates, the participation of the taxpayer's spouse is taken into account.[26]

The Senate Report sets forth several factors (none of which is conclusive) to consider in determining whether involvement in the operations of an activity is regular, continuous, and substantial.[27]

First, a taxpayer is most likely to have materially participated in an activity in cases where involvement in the activity is the taxpayer's principal business. By contrast, when an activity is not a taxpayer's principal business, it is less likely that the taxpayer is materially participating.

Second, a taxpayer is most likely to have materially participated in an activity in cases where the taxpayer is regularly present at the place or places where the principal operations of the activity are conducted.

Third, a taxpayer is most likely to have materially participated in an activity in cases where he performs management functions requiring the exercise of independent discretion and judgment, such as decision making.[28] A taxpayer's role is not substantial if he merely approves management decisions made by others. The Senate Report makes clear that the degree of a taxpayer's knowledge or experience regarding an activity is "highly significant" in determining whether his participation in management is likely to amount to material participation.[29]

These factors together make it clear that taxpayers who are engaged in the business of real estate development, for example, will generally be regarded as materially participating in the projects (with the key exception of rental activity) which they manage and, therefore, will be entitled to apply the losses and credits from such projects against other income. If such taxpayers utilize employees or contract services to perform the daily functions in running the project, that fact alone will not prevent them from qualifying as materially participating, so long as they "personally perform sufficient services to establish material participation." [30]

[26] §469(h)(5).
[27] Senate Report at 732-34. Note also that the Treasury is required under §469(k)(1) to issue regulations specifying what constitutes "material participation."
[28] In this regard, the Conference Report notes that in an agricultural activity, the types of decision-making that may be relevant to a taxpayer's material participation include, but not by way of limitation, decision-making regarding (1) crop rotation, selection, and pricing, (2) the incursion of embryo transplant or breeding expenses, (3) the purchase, sale, and leasing of capital items; (4) breeding and mating decisions; (5) the selection of herd or crop managers who then act at the behest of the taxpayer, rather than as paid advisors directing the conduct of the taxpayer. Conference Report at II-148.
[29] Senate Report at 734.
[30] *Id.*, at 735.

The Conference Report clarifies that "an individual who works full-time in a line of business consisting of one or more business activities generally is likely to be materially participating in those activities (except to the extent provided otherwise in the case of rental activities), even if the individual's role is in management rather than operations." [31] The Conference Report further states that "[t]his clarification is not intended to alter the description of material participation in the Senate Report in any respect. Rather, it recognizes the substantial likelihood that, despite the difficulty in many circumstances of ascertaining whether the management services rendered by an individual are substantial and *bona fide*, such services are likely to be so when the individual is rendering them on a full-time basis and the success of the activity depends in large part upon his exercise of business judgment.[32] Moreover, "a taxpayer is likely to be materially participating in an activity, if he does everything that is required to be done to conduct the activity, even though the actual amount of work to be done to conduct the activity is low in comparison to other activities." [33]

These concepts of material participation were crystallized in two colloquies on the Senate floor between Senators Packwood and Hatfield concerning material participation by owners of hotels (which, as discussed below, are not considered rental activities so that it is not passive *per se*). In these colloquies, Senator Packwood, then Chairman of the Senate Finance Committee, confirmed that a taxpayer who owned a hotel condominium unit would still materially participate in the operation of the hotel if, on a regular, continuous and substantial basis, he engaged in each of the following activities:

1. Establishment of hotel unit's rental rates;

2. Establishment and review of hiring and other personnel policies including review of management personnel;

3. Review and approval of periodic and annual audited financial reports;

4. Preparation of operating and capital expenditure budgets;

5. Establishment of financial reserve requirements;

6. Selection of banks;

7. Participation in meetings concerning the hotel unit with agents and contract management personnel to review operations and business plans to conduct on-site inspections;

8. Participation in off-site business promotion activities;

9. Establishment of procedures for payment of the hotel unit expenses;

10. Review of personal property tax assessments and procedures for payment of property taxes; and

11. Establishment of responsibility for debt service payments.[34]

[31] Conference Report at II-147-48.
[32] *Id.* at II-148.
[33] *Id.*
[34] Cong. Rec. (June 24, 1986) at pp. S8244-S8246; Cong. Rec. (Sept. 27, 1986), p. S13958.

The colloquies emphasize that a hotel unit owner's mere ratification of the decisions of management agents or employees does not constitute material participation in hotel operations. It should be emphasized that these colloquies, although indicative of congressional intent, do not carry the same weight as a committee report. Therefore, it is possible that the Service could issue regulations that reflect additional or different criteria for determining whether a hotel condominium unit owner materially participates in that hotel activity.

b. Closely Held C Corporations and Personal Service Corporations

Closely held C corporations or personal service corporations that are subject to the passive loss rules will be treated as materially participating in an activity with respect to which one or more shareholders, owning in the aggregate more than 50% (by value) of the outstanding stock of the corporation, materially participate. See §469(h)(4)(A). Thus, for example, a corporation with 5 shareholders, each owning 20% of the stock, is treated as materially participating in an activity if three or more of such shareholders so participate. Alternatively, §469(h)(4)(B), by reference to §465(c)(7)(C), provides that a closely held C corporation subject to the passive loss rules may also be treated as materially participating in an activity if:

(i) during the entire 12-month period ending on the last day of the taxable year, the corporation had at least 1 full-time employee substantially all the services of whom were in the active management of the business,

(ii) during the entire 12-month period ending on the last day of the taxable year, the corporation had at least 3 full-time, nonowner employees substantially all of the services of whom were services directly related to the business, and

(iii) the amount of the deductions attributable to the business which are allowable to the taxpayer solely by reason of §§162 and 404 for the taxable year exceeds 15% of the gross income from the business for the year.

Note: As previously mentioned, the two foregoing tests are applied on a group-wide basis in the case of affiliated corporations filing consolidated returns. According to the Conference Report, at II-140, if, for example, one or more shareholders holding more than 50% of a member's stock materially participate in an activity of any member of the group, the group is considered as materially participating. Similarly, if the three requirements that must be met under the alternative test of §469(h)(4)(B) are met by any member (or several members together) as to any activity, then the group is treated as materially participating in the activity.

(1) Closely Held C Corporations

Section 469(j)(1) refers to "closely held C corporations" as defined in §465(a)(1)(B) which, in turn, refers to "a C corporation with respect to which the stock ownership requirement of paragraph (2) of §542(a) is met." Section 542 (defining a personal holding company) provides that the term "personal holding company" means any corporation if *inter alia*, "[a]t any time during the last half of the taxable year more than 50% in value of its outstanding

stock is owned, directly or indirectly, by or for not more than 5 individuals."

(2) Personal Service Corporations

Under §469(j)(2), the term "personal service corporation" has the meaning given such term by §269A(b)(1) which provides that a "personal service corporation" means a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee owners." Section 269A(b)(2) states that an "employee-owner" is "any employee who owns, on any day during the taxable year, more than 10% of the outstanding stock of the personal service corporation." Section 469(j)(2)(A) substitutes "any" for "more than 10%." Section 269A(b)(2) further states that [f]or purposes of the ownership requirement, §318 shall apply, except that "5%" shall be substituted for "50%" in §318(a)(2)(C). Section 318(a)(2)(C) provides that "[i]f 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation." Section 469(j)(2)(B) substitutes "any" for "50% or more in value" in §318(a)(2)(C). Section 469(j)(2) further provides that "[a] corporation shall not be treated as a personal service corporation unless more than 10% of the stock (by value) in such corporation is held by employee-owners (within the meaning of section 269A(b)(2), as modified [herein]."

The broad employee-owner category is a very stringent provision and is made even more so by the fact that stock ownership can be attributed to employees who do not own stock directly. Stock-attribution rules are not unusual, but the attribution rules applied in the passive-activity context make it very difficult for any service corporation to determine whether it is subject to the limitation. A corporation's employees are considered to be "owners" if they own stock in the corporation or if:

They own stock in any other corporation that owns stock in the corporation;

The employee's spouse, children, grandchildren or parents own stock in the corporation; or

Their partnership, partners or a trust or estate in which they are a beneficiary owns stock in the corporation.

For all these purposes, ownership of an option is considered the same as ownership of stock, and more extensive constructive ownership rules apply. Any service corporation would have substantial difficulty in showing that the required number of its employees are not "owners."

Further complicating the situation is the fact that neither "personal services" nor "substantially performed" are defined. While the definition of "personal services" clearly encompasses the trades and professions, there is precedent for treating any activity that produces income, other than the sale of a product or the use of capital, as a personal service. If the broadest definition is used for this purpose, *any* corporation that provides services, rather than products or capital, could be viewed as providing personal services. Examples might include airlines, rent-a-car companies, broadcasting companies, theaters, trucking and delivery companies and railroads. If the services provided by such a company are "personal" and are "substantially" performed by employee-owners, the company is a personal service corporation, provided the aggregate 10% ownership test is met.

With regard to the "substantially performed" test, any definition would clearly be satisfied by service companies where only employees own stock and would frequently apply to those with a high percentage of employees owning stock. However, in many service companies, even those with thousands of employees and with no stock ownership incentives, a narrow definition could still apply. Under a broad definition of the term, if the service is "personal," but is provided by the organization as a whole rather than by a particular employee, it is possible that the service will be deemed to be "substantially performed" by management, and, as a result, stock ownership by management employees would be the relevant criterion.

Finally, note that "[i]n the case of a personal service corporation which is a member of a consolidated group, similar principles are intended to apply. For example, a corporation may be treated as a personal service corporation for purposes of the rule where the owners who render the requisite services are employees of a subsidiary, rather than of the parent corporation.[35]

c. Limited Partnerships

Section 469(h)(2) provides that "[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates." When a taxpayer is both a limited and a general partner in a limited partnership, lack of material participation is conclusively presumed with respect to the limited partnership interest and the taxpayer must prove that he is materially participating as a general partner in the activity of the limited partnership.

The Secretary is empowered under §469(k)(3) to provide regulations "requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity." This grant of authority should be used to "prevent taxpayers from manipulating the rule that limited partnerships generally are passive, in attempting to evade the passive loss provision." [36]

d. Treatment of Retired Individuals and Surviving Spouses Participating in Farming Activity

Section 469(h)(3) provides that a taxpayer is materially participating in any farming activity for a taxable year if §2032A(b)(4) or (5) "would cause the requirements of §2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year."

Section 2032A(b)(1)(C)(ii) provides that one of the elements of the definition of "qualified real property" (for

[35] Conference Report at II-140.
[36] Senate Report at 731.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

purposes of estate tax valuation of certain farm real property) is that "during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which * * * there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business."

Section 2032A(b)(4) provides in relevant part that "[i]f, on the date of the decedent's death the requirements of paragraph (1)(C)(ii) with respect to the decedent for any property are not met, and the decedent—(i) was receiving old-age benefits under title II of the Social Security Act for a continuous period ending on such date, or (ii) was disabled for a continuous period ending on such date, then paragraph (1)(C)(ii) shall be applied with respect to such property by substituting 'the date on which the longer of such continuous periods began' for 'the date of the decedent's death' in paragraph (1)(C)."

Section 2032A(b)(5)(C) provides that "[i]n any case in which to do so will enable the requirements of paragraph (1)(C)(ii) to be met with respect to the surviving spouse, this subsection and subsection (c) [regarding tax treatment of dispositions and failures to use for qualified use] shall be applied by taking into account any application of paragraph (4)."

3. Rental Activity

The Senate Report states that the "extensive use of rental activities for tax shelter purposes under present law, combined with the reduced level of personal involvement necessary to conduct such activities, make clear that the effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities." [37] Accordingly, §469(c)(2) provides that the term "passive activity" includes "any rental activity," regardless of whether the taxpayer materially participates in the activity.

a. Defining Rental Activity

Section 469(j)(8) defines "rental activity" as any activity where payments are principally for the use of tangible property. Under this standard, an activity will generally be regarded as rental activity if it involves a long-term rental period and a low turnover in the lessees of the property, or if expenses of day-to-day operations are insignificant in relation to rents produced by the property, or in relation to the amount of the depreciation and the cost of carrying the rental property.

On the other hand, if "significant services" are provided generally in connection with the use of any property, the activity may not be considered a rental activity under the passive loss rules.[38] For example, because of the services provided to guests (such as maid service, room service, valet service, etc.), renting hotel rooms, resort condominiums or similar facilities on a daily or weekly basis would not constitute "rental activities" under the general rules and, therefore, could *not* be a real estate rental activity for purposes of the special $25,000 allowance for real estate rentals (examined below). However, the passive activity loss limitation may still not apply if the material participation standard is met.

Long-term rental periods and low turnover of lessees indicate a rental activity, whereas short rental periods and heavy tenant turnover may cause an activity not to be a rental activity, especially if significant services are provided. It is not clear whether nursing homes and elderly care facilities that are rented on a continuous basis and provide some services will be considered rental activities.[39]

Note: The Senate Report, at 741, provides that the S corporation rules concerning rental income provide a "useful analogy" in determining whether an activity is a rental activity for §469 purposes. Consequently, the following revenue rulings, determining that income received by a subchapter S corporation was not rent, may prove instructive in the passive loss area:

Rev. Rul. 61-112, 1961-1 C.B. 399, ruling that amounts received under a share-farming arrangement are not "rents" when the taxpayer participates to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both.

Rev. Rul. 64-232, 1964-2 C.B. 334, concluding that amounts received from leasing glassware, silverware, tables, chairs and electronic equipment are not rents where the taxpayer performs delivery and pickup functions with respect to the items and washes, polishes, repairs and stores them prior to their lease to a customer.

Rev. Rul. 65-83, 1965-1 C.B. 430, ruling that construction barricade, golf cart, crane, and dress suit rentals were not "rents" due to the significant services performed in connection with the rentals.

Rev. Rul. 65-91, 1965-1 C.B. 431, providing that (i) fees for the storage of grain are not rents because of the services that are performed in inspecting and turning the grain in order to prevent spoilage and infestation; (ii) payments received for the handling and storage within a refrigerated warehouse are not rents where the owner of the warehouse supplies the necessary labor for moving the goods in and out of the warehouse and is responsible for providing housekeeping services, refrigeration, maintenance and other necessary services; and (iii) amounts received from the operation of a parking lot where the vehicles are parked by attendants are not rents.

Rev. Rul. 65-40, 1965-1 C.B. 429, stating that amounts received for the short-term leasing of motor vehicles are not rents where the lessor furnishes maintenance, gas and oil, tire repair and changing, cleaning and polishing, oil changing and lubrication, and engine and body repair.

Rev. Rul. 70-110, 1970-1 C.B. 176, ruling that demurrage, which is the exchange made by a transportation company or shipper for unreasonable detention of its

[37] *Id.* at 718.
[38] *Id.* at 742.
[39] Note, however, that the Conference Report, at II-138, clarifies that a net lease of property is rental activity that is treated as a passive activity.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

shipping containers (railroad cars, ships, air cargo pallets, etc.) is not rent.

Rev. Rul. 70-206, 1970-1 C.B. 177, determining that payments received for making television sets available to hospital patients and for required services, including unlocking and locking and adjusting and repairing the sets, are not rents.

Rev. Rul. 75-349, 1975-2 C.B. 349, concluding that a subchapter S corporation that distributes feature length motion pictures to exhibitors for a share of the box office receipts and does support work, prepares advertising, furnishes advance personnel, inspects theaters, and delivers and picks up the films, or that itself rents theaters to exhibit the films and retains all the box office receipts, does not receive rents.

Rev. Rul. 76-48, 1976-1 C.B. 265, ruling that amounts received for the use of tennis and handball courts by players who are provided with locker room and parking facilities, lesson fees with no additional charge made for the use of the court, and sales of sport items by a shop on the premises, are not rents.

Rev. Rul. 76-469, 1976-2 C.B. 252, providing that amounts received as part of a business of leasing motor vehicles under long-term leases are not rents where the lessor provides maintenance, repair and other significant services to the lessee.

Rev. Rul. 81-197, 1981-2 C.B. 166 (Situation Two) ruling that the chartering of aircraft to provide transportation where the aircraft owner retains possession, command, and control of the aircraft was not a lease arrangement but rather the furnishing of the aircraft.

b. Special Rule for Rental Real Estate Activities

Although by deeming rental activity to be intrinsically passive Congress effectively eliminated rental activity as a viable form of tax shelter, it nevertheless determined that a "limited measure of relief * * * [is] appropriate in the case of certain moderate-income investors in rental real estate, who otherwise might experience cash flow difficulties with respect to investments that in many cases are designed to provide financial security, rather than to shelter a substantial amount of other income." [40] Thus, up to $25,000 of losses and credits (in a deduction equivalent sense) from rental real estate activities in which "any natural person" "actively participates" (as defined below) may be used to offset nonpassive income of the taxpayer.[41]

The $25,000 allowance is applied by first netting income and loss from all of the taxpayer's rental real estate activities in which he actively participates. If there is a net loss for the year from such activities, net passive income (if any) from other activities is then applied against it, in determining the amount eligible for the $25,000 allowance.[42]

Example: Assume taxpayer A has $25,000 of losses from a rental real estate activity in which he actively participates. If A also actively participates in another rental real estate activity, from which he has $25,000 of gain, resulting in no net loss from rental real estate activities in which he actively participates, then no amount is allowed under the $25,000 allowance for the year.

(1) Active Participation

Section 469(i)(6)(A) provides that an individual is not actively participating in a rental real estate activity for any period if, at any time during the period, the interest (including any interest of the individual's spouse) is less than 10% (by value) of all interests in the activity. For purposes of determining whether a taxpayer's interest in the activity amounts to at least 10%, "separate buildings are treated as separate rental real estate activities if the degree of integration of the business and other relevant factors do not require treating them as parts of a larger activity (e.g., an integrated shopping center)." [43]

Once the taxpayer has met the 10% ownership test, he must establish active participation in the activity.[44] The Senate Report makes clear that, unlike the material participation standard, the active participation test can be satisfied without regular, continuous, and substantial involvement in operations, "so long as the taxpayer participates, e.g., in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and *bona fide* sense. Management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions." [45] In addition, "a lessor under a net lease is unlikely to have the degree of involvement which active participation entails," although leasing space pursuant to a net lease would otherwise qualify as "rental activity." [46] The Committee Report further states that "services provided by an agent are not attributed to the principal, and a merely formal and nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment, is insufficient." [47] Thus, the bottom line appears to be that if the taxpayer makes the important management decisions, and exercises independent judgment in doing so, he will be considered to actively participate in an activity. Regardless of the scope of a limited partner's participation in an activity, §469(i)(6)(C) provides that no interest as a limited partner in a limited partnership shall be treated as an interest with respect to which the taxpayer actively participates.

Finally, note that the Treasury is required under §469(k)(1) to issue regulations which specify what constitutes "active participation."

[40] Senate Report at 718.

[41] §469(i). The Conference Report, at II-142, clarifies that a trust is not intended to qualify for the $25,000 allowance "so that individuals cannot circumvent the $25,000 ceiling, or multiply the number of $25,000 allowances, simply by transferring various rental real properties to one or more trusts."

[42] Conference Report at II-141.

[43] Senate Report at 743.

[44] Note that, as with the material participation standard, in determining whether a taxpayer actively participates, the participation of the taxpayer's spouse will be taken into account. §469(i)(6)(D).

[45] Senate Report at 737-38.

[46] *Id.* at 738, 742.

[47] *Id.* at 738.

(2) Phase-Out of Allowance

As a general rule, the $25,000 is phased out by 50% of the amount by which the taxpayer's adjusted gross income for the year (calculated without regard to net passive losses, deductible IRA contributions, or taxable social security benefits) exceeds $100,000.[48] Thus, the $25,000 offset is disallowed totally for taxpayers with adjusted gross income above $150,000. For the rehabilitation investment credit described in §48(o) and the low-income housing credit described in §42, (i) the phase-out range is increased to between $200,000 and $250,000 of adjusted gross income, and (ii) the offset is allowed regardless of whether the taxpayer actively participates in the activity generating the credits.[49]

In the case of the low income housing credit, the waiver of the active participation requirement applies only to property placed in service before 1990. However, if the property is placed in service in 1990, the active participation requirement is waived if at least 10% of the total project costs are incurred before 1989.[50]

(3) Special Rule for Estates

Section 469(i)(4)(A) provides that an estate is deemed to actively participate, for the two years following the taxpayer's death, in a rental real estate activity in which the taxpayer actively participated before his death. Thus, the taxpayer's estate may continue to receive the same tax treatment with respect to the rental real estate activity as did the taxpayer in the taxable year of his death. The rationale for this provision is "to facilitate the administration of the estate without requiring the executor or fiduciary to reach decisions with respect to the appropriate disposition of the rental real property within a short period following the taxpayer's death." [51]

Section 469(i)(4)(B) provides that for purposes of the special two year rule, the $25,000 dollar limitation will be reduced by the amount of the exemption under §469(i)(1) (without regard to the phase-out) allowable to the decedent's surviving spouse for the taxable year ending with or within the taxable year of the estate.

(4) Married Individuals Filing Separately

Section 469(i)(5)(A) provides that the amount of the $25,000 allowance, and the adjusted gross income ranges in which the allowance is phased out (*i.e.*, $100,000 to $150,000, except in the case of certain credits where the range is $200,000 to $250,000) is halved in the case of married individuals filing separate returns. Section 469(i)(5)(B) states that the above limitation shall not apply to a taxpayer who is a "married individual filing a separate return for any taxable year" and "does not live apart from his spouse at all times during such taxable year." In such cases, the Conference Report states that the amount of the $25,000 allowance is reduced to zero.[52] Absent such a rule, "married taxpayers where one spouse would be eligible for a portion of the $25,000 amount if they filed separately would have an incentive so to file; the conferees believe that rules that encourage filing separate returns give rise to unnecessary complexity and place an unwarranted burden on the administration of the tax system." [53] The Treasury is given regulatory authority to deal with changes in marital status and changes between joint returns and separate returns to carry out these and other provisions set forth in §469.[54]

B. Treatment of Losses and Credits

1. Losses

a. General Rules

Section 469(a)(1)(A) provides that the passive activity loss rules apply to any individual, estate or trust, any closely held C corporation, and any personal service corporation. Under §469(d)(1), the determination of passive activity loss is made on an aggregate basis. Thus, losses from passive activities may only offset income from other passive activities.

For example, assume than an individual has a net loss of $10,000 from his investment in rental housing (in which he does not actively participate) and a net income of $10,000 from a "non-working" limited partnership interest in an oil and gas venture (or from any other business in which he is not a material participant). The individual would have neither passive activity income nor passive activity loss, since the passive loss nets out the passive income.

On the other hand, if the above individual has $20,000 of passive activity losses, he would have a $10,000 passive activity loss. Section 469(b) states that such a "suspended" passive activity loss for the year is carried forward indefinitely, but not carried back, and is allowed in subsequent years against passive activity income. Section 469(j)(4) further provides that "[t]he passive activity loss and the passive activity credit (and the $25,000 amount under subsection (i)) shall be allocated to activities, and within activities, on a pro rata basis in such manner as the Secretary may prescribe."

For each separate activity, the portion of the loss that is suspended and carried forward is determined by the ratio of net losses from that activity to the total net losses from all passive activities for the year. Such an allocation is necessary in order to determine the cumulative suspended losses for any particular activity which are then allowed in full upon disposition. The application of these rules is demonstrated in the following example, for years after 1990. Substantially different rules apply during the 1987-1990 transition period (discussed below).

Example: Assume taxpayer X owns three rental buildings in which he does not actively participate. He has $25,000 of net losses from Building A and $15,000 of net losses from Building B. Building C produces $20,000 of rental income. X can offset the $20,000 of passive income with $20,000 of passive losses. The $20,000 of remaining loss is suspended and is allocated as follows:

[48] §469(i)(3)(A).
[49] §469(i)(6)(B), (i)(3)(B).
[50] Act §501(c)(3).
[51] Conference Report at II-142.
[52] *Id.*
[53] *Id.*
[54] §469(k)(5).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

$12,500 to Building A (*i.e.*, $20,000 net passive loss × $25,000/$40,000)

$7,500 to Building B (*i.e.*, $20,000 net passive loss × $15,000/$40,000)

In the case of the $25,000 allowance for passive losses from rental real estate activities in which the taxpayer actively participates, a situation could arise in which losses would be allowable for the year under the passive loss rule, but the taxpayer has insufficient (or no) nonpassive income against which to apply them. The Senate Report states that in such a case, "the otherwise allowable rental real estate losses are thereupon treated as losses which are not from a passive activity. They are treated as net operating losses (NOLs) arising in that year, and may be carried forward and back in accordance with the rules applicable to NOLs." [55]

The Senate Report further points out that in the case of individuals, estates and trusts, and personal service corporations, "nonpassive losses and NOLs are taken into account only after reducing income from passive activities by current and suspended deductions from passive activities (but not below zero). * * * This permits the taxpayer to obtain the full benefit of suspended passive activity losses * * * before using any losses that are not from passive activities (or NOL carryovers). If a taxpayer has net passive activity income for the year (after the application of all suspended passive losses), the income may be offset by current-year nonpassive losses and by NOL carryovers." [56]

b. Special Rule for Closely Held Corporations

Section 469(e)(2)(A) provides that "[i]f a closely held C corporation (other than a personal service corporation) has net active income for any taxable year, the passive activity loss of such taxpayer for such taxable year (determined without regard to this paragraph)—(i) shall be allowable as a deduction against net active income, and (ii) shall not be taken into account under subsection (a) to the extent so allowable as a deduction. A similar rule shall apply in the case of any passive activity credit of the taxpayer." Section 469(e)(2)(B) defines "net active income" as the "taxable income of the taxpayer for the taxable year determined without regard to—(i) any income or loss from a passive activity, and (ii) any item of gross income, expense, gain, or loss described in paragraph (1)(A) [relating to portfolio income]." [57]

Thus, while closely held C corporations (other than personal service corporations) are not permitted to use passive-activity losses to reduce portfolio income, the losses can be used to offset income from the corporation's active businesses. Accordingly, these corporations can use tax shelter losses with relatively few restrictions and may find such investments relatively attractive.

c. Relation to Investment Interest Limitation

Section 163(d)(4)(D) provides that interest deductions attributable to passive activities are treated as passive activity deductions, not as investment interest. Thus, such interest deductions are subject to limitation under the passive loss rule, and not under the investment interest limitation. The Conference Report further clarifies that "income and loss from passive activities generally are not treated as investment income or loss in calculating the amount of the investment interest limitation." [58] However, under §163(d)(4)(E), any passive losses allowed by reason of the phase-in of the passive loss rules (discussed below)—other than losses from rental real estate activities in which the taxpayer actively participates—reduce net investment income.

d. Relation to At-Risk Rules

The determination of whether a loss is suspended under the passive loss rules is made after the application of the amended at-risk rules. The Senate Report states that a "loss that would not be allowed for the year because the taxpayer is not at risk with respect to it is suspended under the at-risk provision, not the passive loss rule. * * * Such amounts may become subject to the passive loss rule in subsequent years when they would be allowable under the at-risk * * * limitations." [59] The Report further provides that "[a]mounts at risk are reduced even if deductions which would be allowed under the at-risk rules are suspended under the passive loss rule. Similarly, basis is reduced as under present law, even in the case where deductions are suspended under the passive loss rule. However, if an amount at risk or basis has been reduced by a deduction not allowed under the passive loss rule, the amount at risk or basis is not again reduced when the deduction becomes allowable under the passive loss rule." [60]

e. Special Rule for Qualified Residence Interest

Section 469(j)(7) provides that passive activity losses shall be computed without regard to "qualified residence interest." Section 163(h)(3)(A) defines qualified residence interest as interest paid or accrued during the taxable year on indebtedness secured by any property which (at the time the interest is paid or accrued) is a qualified residence of the taxpayer. Section 163(h)(3)(B) provides that qualified residence interest shall not include "any interest paid or accrued on indebtedness secured by any qualified residence which is allocable to that portion of the principal amount of such indebtedness which, when added to the outstanding aggregate principal amount of all other indebtedness previously incurred and secured by such qualified residence, exceeds the lesser of—(i) the fair market value of such qualified residence, or (ii) the sum of—(I) the taxpayer's basis in such qualified residence (adjusted only by the cost of any improvements to such residence), plus (II) the aggregate amount of qualified indebtedness of the taxpayer with respect to such qualified residence." Section 163(h)(5)(A) defines "qualified residence" as the principal residence (under §1034) of the taxpayer, and one other residence of the taxpayer which he selects for purposes of

[55] Senate Report at 722.
[56] *Id.* at 722-23.
[57] Note that §469(e)(4) provides, for purposes of paragraph (2), that income from dividends shall be reduced by the amount of any dividends received deduction under §243, §244, or §245.
[58] Conference Report at II-139.
[59] Senate Report at 723. The Report further notes that "[d]uring the 5-year period over which the passive loss rule is phased in, these rules interact in the same manner.
[60] *Id.*, footnote 9.

this subsection for the taxable year and which he uses as a residence within the meaning of §280A(d)(1).

2. Credits

a. General Rules

Section 469(a) provides that "the passive activity credit" for the taxable year shall not be allowed for any individual, estate or trust, any closely held C corporation, and any personal service corporation. Under §469(d)(2), the term "passive activity credit" is defined as the amount (if any) by which "(A) the sum of the credits from all passive activities allowed for the taxable year under—(i) subpart D of part IV of subchapter A [(*i.e.*, the transitional investment credit, the jobs credit, the research credit, the low-income housing credit and the rehabilitation tax credit)], or (ii) subpart B (other than §27(a) [regarding the foreign tax credit] of such part IV [(*i.e.*, the credit for clinical testing expenses for certain drugs for rare diseases or conditions determined under §28 and the credit for producing fuel from a nonconventional source determined under §29)], exceeds (B) the regular tax liability of the taxpayer for the taxable year allocable to all passive activities." [61] In other words, if the taxpayer has an aggregate passive activity loss for the year, no tax credits from passive activities can be used currently, even though the taxpayer has a net regular tax liability for the year.

As with disallowed passive activity losses, disallowed credits can be carried forward indefinitely until there is regular tax liability from passive activities to trigger their use.[62] At that time, the credits lose their character as passive activity credits to the extent of the regular tax liability from passive activities and are aggregated with any other credits for the year to determine the limitations on their use and how they are to be used.[63]

b. Interaction with Other Credit Limitations

For taxable years beginning after 1986, §38(c) provides that the general business credit may not exceed the lesser of (i) the first $25,000 of a taxpayer's net regular tax liability plus 75% of the excess, or (ii) the excess, if any, of the taxpayer's net regular tax liability over the tentative minimum tax. This overall limitation is applied after the amount of credits allowable under the passive loss rule is determined.[64] However, the limitation on the credit for research and development activities to the tax on income from such activities is applied before the passive loss limitation is applied to such credits.[65]

c. Relation to the $25,000 Real Estate Rental Allowance

The Senate Report makes clear that passive credits may be allowable to offset tax on nonpassive income with respect to the $25,000 real estate rental offset.[66] In applying the $25,000 allowance, credits are converted to a "deduction equivalent." Section 469(j)(5) provides that "[t]he deduction equivalent of credits from a passive activity for any taxable year is the amount which (if allowed as a deduction) would reduce the regular tax liability for such taxable year by an amount equal to such credits." Assuming a 28% marginal tax rate, the $25,000 allowance is equivalent to a $7,000 credit.

Credits are allowed to offset tax on the portion of the $25,000 allowance that the taxpayer has not been able to offset by the use of the deductions. The amount of tax on such remaining portion (and thus the amount of credits that can be used against other income) is determined by comparing (i) the amount that the taxpayer would owe (disregarding credits) with respect to income other than any net passive losses, but reduced by rental real estate deductions in the amount allowable under the $25,000 rule, with (ii) the amount that the taxpayer would owe (again disregarding credits) if the allowable rental real estate deductions equaled $25,000 (or less as appropriate, *i.e.*, in the phase-out range for this amount.[67]

3. Activity No Longer Treated As Passive

Section 469(f)(1) provides that, with respect to either active participation or material participation, a change in the nature of the taxpayer's involvement in an activity does not trigger the allowance of deductions carried over from prior taxable years. Thus, for example, if a taxpayer begins to participate actively in an activity in which, in prior years, he did not actively participate, the rule allowing up to $25,000 of losses from rental real estate activities against nonpassive income will not apply to losses from the activity carried over from such prior years. The same rule applies to credits, to the extent that active participation is relevant to their allowability. By contrast, the Conference Report notes that "losses (or credits) carried over from a year in which the taxpayer did actively participate, but that were not allowed against nonpassive income in such year because they exceeded $25,000 (as reduced by the applicable AGI phase-out), are deductible (or allowable) under the $25,000 rule in a subsequent year, but only if the taxpayer is actively participating in the activity in such subsequent year." [68]

4. Change in Status of Closely Held C Corporation or Personal Service Corporation

Section 469(f)(2) provides that "[i]f a taxpayer ceases for any taxable year to be a closely held C corporation or personal service corporation, this section shall continue to apply to losses and credits to which this section applied for any preceding taxable year in the same manner as if such taxpayer continued to be a closely held C corporation or personal service corporation, whichever is applicable." In other words, if a closely held C corporation or a personal service corporation ceases to meet the definition of a closely held C corporation or personal service corporation, respectively, subject to the passive loss rule in any year, losses from a passive activity conducted by the corporation and previously suspended by reason of the application of the passive loss rule are not triggered by the change in status,

[61] Section 469(j)(3) defines "regular tax liability" by reference to §26(b), which refers to the tax imposed by Chapter 1 ("Normal Taxes and Surtaxes") of the Code.
[62] §469(b).
[63] Senate Report at 724.
[64] *Id.*
[65] *Id.*
[66] Senate Report at 724.
[67] *Id.*
[68] Conference Report at II-141, footnote 2.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

but are allowed against income from that activity. Any previously suspended losses and (deduction equivalent) credits in excess of income from the activity continue to be treated as from a passive activity. Losses and credits from an activity arising in a year when the corporation does not meet the definition of either a closely held C corporation or a personal service corporation, respectively, are not subject to the limitation under the passive loss rule.

5. Dispositions

a. General Rule

Section 469(g)(1) provides that if during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity) in a fully taxable transaction, "any loss from such activity which has not previously been allowed as a deduction (and in the case of a passive activity for the taxable year, any loss realized on such disposition) shall not be treated as a passive activity loss and shall be allowable as a deduction against income in the following order: (i) Income or gain from the passive activity for the taxable year (including any gain recognized on the disposition). (ii) Net income or gain for the taxable year from all passive activities. (iii) Any other income or gain."

The Senate Report states that "[the reason for this rule is that, prior to a disposition of the taxpayer's interest, it is difficult to determine whether there has actually been gain or loss with respect to the activity." [69] Once there is no possibility that the taxpayer will recognize any additional income from a passive activity, there is no justification for continued suspension of any losses from that activity. A disposition of the "entire interest" guarantees there will be no future income produced, and a "fully taxable" transaction ensures that any inherent taxable gain is recognized currently.

Example: Taxpayer X has been involved in two rental activities (*i.e.*, Building A and Building B), and no other passive activities. Building A, with respect to which X has $100 of suspended losses, is sold for a gain of $50. Building B produces net income of $25 for the year. The $100 of suspended losses for Building A first offsets the $50 gain on the sale of Building A. The remaining $50 of loss offsets the $25 of passive income from Building B and $25 of other income of the individual.

It is unclear whether a gain realized on the sale of one passive activity (net of the suspended losses on the activity) can be offset by passive losses from other activities. Since the disposition rule operates on an activity-by-activity basis, it may be that it cannot. If so, any such gain would appear to be taxable in the year of disposition.

b. Disposition of Entire Interest

For a disposition of a passive activity to be complete, the taxpayer must dispose of all interests he holds in entities engaged in the activity as well as all assets used in the activity that he may own directly. If a partnership (general or limited) or S corporation conducts two separate activities, fully taxable disposition by the entity of all the assets used or created in one activity constitutes a disposition of the partner's or shareholder's entire interest in the activity. Similarly, if a grantor trust conducts two separate activities and sells all the assets used or created in one activity, the grantor is considered as disposing of his entire interest in that activity. The Senate Report stresses the importance of maintaining "adequate records" of the suspended losses that are allocable to a particular activity in order for such losses to be allowed in full upon disposition of the taxpayer's interest in such activity.[70]

It bears noting that because any gain from the disposition of a passive activity or from the sale of assets used in a passive activity produces current-year passive activity income, suspended losses from an activity can be used to offset that gain *regardless* of whether the disposition is complete and fully taxable.

c. Fully Taxable Transaction

An exchange of the taxpayer's interest in an activity in a nonrecognition transaction, such as an exchange governed by §§351, 721, or 1031 in which no gain or loss is recognized, does not trigger suspended losses. The Conference Report clarifies, moreover, that "a transaction constituting a sale (or other taxable disposition) in form, to the extent not treated as a taxable disposition under general tax rules, does not give rise to the allowance of suspended deductions. For example, sham transactions, wash sales, and transfers not properly treated as sales due to the existence of a put, call, or similar right relating to repurchase, do not give rise to the allowance of suspended losses." [71]

d. Related Party Transactions

Under §469(g)(1)(B), a taxpayer is not treated as having disposed of an interest in a passive activity, for purposes of triggering suspended losses, if he disposes of it in an otherwise fully taxable transaction to a related party (within the meaning of §267(b) or §707(b)(1), including applicable attribution rules).[72] In the event of such a related party transaction, because it is not treated as a disposition for purposes of the passive loss rule, suspended losses are not triggered, but rather remain with the taxpayer. Such suspended losses may be offset by income from other passive activities of the taxpayer.

When the entire interest owned by the taxpayer and the interest transferred to the related transferee in the passive activity are transferred to a party who is not related to the taxpayer (within the meaning of §267(b) or §707(b)(1), including applicable attribution rules) in a fully taxable transaction, then to the extent the transfer would otherwise qualify as a disposition triggering suspended losses, the taxpayer may deduct the suspended losses attributable to his interest in the passive activity.

e. Interaction with Capital Loss Limitation

Section 469(g)(1)(C) provides that to the extent that any loss recognized upon a fully taxable disposition of a

[69] Senate Report at 725.

[70] *Id.* at 725-26.

[71] Conference Report at II-143.

[72] The test under these related party provisions can be met if there is a family or fiduciary relationship between the taxpayer and the transferee. The test will also be met if certain business relationships exist, generally based on a greater-than-50% common ownership interest existing between the taxpayer and the transferee.

taxpayer's entire interest in a passive activity is a loss from the sale or exchange of a capital asset, it is limited to the amount of gains from the sale or exchange of capital assets plus $3,000 (in the case of individuals). The capital loss limit is applied *before* the determination of the amount of losses upon a disposition under the passive loss rules.

Example: Taxpayer A has a capital loss of $10,000 upon the disposition of a passive activity. The disposition triggers the allowance of $5,000 of previously suspended ordinary losses. However, the capital loss deduction is limited to $3,000 for the year (assuming the taxpayer has no other gains or losses from the sale of capital assets for the year). The remainder of the capital loss from the disposition is carried forward and allowed in accordance with the provisions determining the allowance of such capital losses.

f. Disposition by Death

Section 469(g)(2) provides that if a taxpayer engaged in a passive activity dies, the suspended passive activity losses will be allowed on the decedent's final return to the extent such losses are greater than the excess (if any) of (1) the basis of such property in the hands of the transferee (generally "stepped up" to its fair market value at date of death) over (2) the adjusted basis of such property immediately before the death of the taxpayer. Any losses to the extent of such excess are not available as a deduction for any taxable year. The net effect is similar to taxing part of the step-up in basis.

These rules apply on an activity-by-activity basis rather than to the aggregate of the passive activities of the decedent. Thus, a decedent's total passive activity losses may not be reduced by the full amount of the step-up in the bases of his interests in such passive activities.

Example: Decedent X was engaged in the rental of Buildings A and B prior to his death. The passive activity loss from Building A is $4,000. The excess of the basis of Building A in the hands of the transferee ($5,000) over the decedent's adjusted basis ($2,000) in the property is $3,000. The passive activity loss allowed by reason of death, therefore, is $1,000. The excess of the basis of Building B in the hands of the transferee ($50,000) over the decedent's adjusted basis ($10,000) is $40,000. The aggregate amount of such excess amounts ($43,000) far exceeds the aggregate passive activity losses for Building B ($4,000). Thus, the passive activity loss from Building B is zero. However, because the disposition by death rules apply on an activity by activity basis, $1,000 of passive activity losses from Building A is nevertheless allowed in the year of death.

g. Installment Sales

In the case of installment sales of an entire interest in a passive activity, §469(g)(3) modifies the normal rule that accumulated passive losses are fully deductible in the year the activity is disposed of. In such cases, suspended losses are allowed in each taxable year of the installment obligation in the same ratio as the gain recognized on such sale during each such taxable year bears to the gross profit from the sale realized (or to be realized) when payment is completed. For example, if 10% of the installment gain is recognized in the year of sale, 10% of the accumulated passive activity losses will be deductible in that year.

In IRS Advance Notice 87-8, reprinted in the January 5, 1987 issue of the *Tax Management Weekly Report*, the IRS clarified that, under temporary regulations to be issued, if a taxpayer sells an interest in an activity in a taxable year beginning after December 31, 1986, and the income from the activity is passive under §469, the gain on the sale is passive income for purposes of §469. Gain from such a sale is income from a passive activity as recognized under the installment method of reporting.

The Service also explained that gain from sales in taxable years beginning before 1987 is not income from a passive activity.

h. Gifts

Section 469(j)(6) provides that a gift of all or part of the taxpayer's interest in a passive activity does not trigger suspended losses. Suspended losses are added to the basis of the property immediately before the gift. Suspended losses of the donor are eliminated when added to the donor's basis, and are not allowable as a deduction for any taxable year.

While this rule sounds simple, in practice it can become very complex. For one thing, it theoretically requires a portion of the suspended passive activity loss allocated to the passive activity to be further allocated in even greater detail to the specific assets of that activity. Also, if the passive activity is held in partnership form, the partnership does not increase its basis in the assets.

i. Abandonment

The Conference Report states that "[t]he scope of a disposition triggering suspended losses under the passive loss rule includes an abandonment, constituting a fully taxable event under present law, of the taxpayer's entire interest in a passive activity. Thus, for example, if the taxpayer owns rental property which he abandons in a taxable event which would give rise to a deduction under §165(a) of present law, the abandonment constitutes a taxable disposition that triggers the recognition of suspended losses under the passive loss rule." [73]

j. Basis Adjustment for Credits

Section 469(j)(9) provides an election in the case of a fully taxable disposition of an interest in an activity in connection with which a basis adjustment was made as a result of placing in service property for which a credit was taken. Upon such a disposition, the taxpayer may elect to increase the basis of the credit property (by an amount no greater than the amount of the original basis reduction of the property) to the extent that the credit has not theretofore been allowed by reason of the passive loss rule. At the time of the basis adjustment election, the amount of the suspended credit which may thereafter be applied against tax liability is reduced by the amount of the basis adjustment.

Example: Taxpayer X places in service rehabilitation credit property which generates an allowable credit of $1,000. The basis of the property is reduced by $1,000 as required under the provisions governing the rehabilitation tax credit. However, Taxpayer X is prevented under the

[73] Conference Report at II-143-44.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

passive loss rule from taking any portion of the credit. In a subsequent year, having been allowed no portion of the credit by virtue of the passive loss rule, Taxpayer X disposes of his entire interest in the activity in a fully taxable transaction, including the property whose basis was reduced. Immediately prior to the disposition, Taxpayer X elects to increase the basis of the credit property by $1,000 (*i.e.*, the amount of the original basis adjustment).

k. Changes in Nature of Activity

The Conference Report clarifies that "[t]he fact that the nature of an activity changes in the course of its development does not give rise to a disposition for purposes of the passive loss provision. For example, when a real estate construction activity becomes a rental activity upon the completion of construction and the commencement of renting the constructed building, the change is not treated as a disposition." [74]

C. *Treatment of Portfolio Income*

1. General Rule

Section 469(e)(1)(A) provides that, in determining the income or loss from any passive activity, there shall *not* be taken into account (1) any "portfolio income"; (2) expenses (other than interest) which are "clearly and directly" allocable to portfolio income; (3) interest expense "properly" allocable to portfolio income; and (4) gain or loss attributable to the disposition of property either (a) producing portfolio income or (b) held for investment. Any interest in a passive activity is not treated as property "held for investment" for purposes of §469(e)(1)(A).

The term "portfolio income" for these purposes generally includes "gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business," [75] or, in other words, gross income from activities traditionally regarded to be investments. These include investments in stocks, bonds and other assets that produce such income, as well as other assets "held for investment." [76] Production of interest, dividend or royalty income does not necessarily classify an activity as a portfolio activity, however. For example, dividend and interest income produced by a dealer in securities is "derived in the ordinary course" of the securities business and, therefore, does not qualify as portfolio income.

Section 469(e)(1)(B) further provides that for purposes of determining portfolio income, "any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business." [77] Thus, for example, interest earned on funds set aside by a limited partnership operating a shopping mall, for the purpose of expanding the mall, is treated as portfolio income and is not taken into account in determining a limited partner's passive income or loss from the activity of operating a shopping mall.

2. Loans Made to Pass-through Entities

The Conference Report provides some guidance on the treatment of the return earned on loans made to pass-through entities.[78] If the lender has an ownership interest in the entity, the interest income on the loan will be treated as a non-portfolio item to the extent the lender is allocated a share of the entity's interest expense on that loan. In the case of a partnership, this rule would be applied without regard to any special allocation of interest expense to the lender.

Example: Taxpayer X is a 10% partner in a partnership to which he has made a loan. X receives $1,000 of interest income on the loan. Under normal partnership rules, X would be allocated $100 of interest expense. Economically, X should end up with $900 in net taxable interest income as a result of the loan. The special rule stated in the Conference Report achieves this result by treating $100 of the interest income as a passive activity item, eligible to be offset by the $100 deduction, and the $900 balance as portfolio income, not eligible to be offset by passive losses.

The conferees intend that Treasury issue regulations to provide the above result. According to the Conference Report, "[s]uch regulations may also, to the extent appropriate, identify other situations in which [such] netting * * * is appropriate with respect to a payment to a taxpayer by an entity in which he has an ownership interest. Such netting should not, however, permit any passive deductions to offset nonpassive income except to the extent of the taxpayer's allocable share of the specific payment at issue. Such regulations may, if appropriate, provide that taxpayer's allocable share of the payment for this purpose will be determined without regard to special allocations." [79]

3. Regulations re Expenses Allocable to Portfolio Income

Section 469(k)(4) requires the Treasury to prescribe regulations as may be necessary or appropriate to carry out provisions of this section, including regulations "which provide for the determination of the allocation of interest expense for purposes of this section." The Conference Report states that "[t]he conferees anticipate that regulations providing guidance to taxpayers with respect to interest allocation will be issued by December 31, 1986. These regulations should be consistent with the purpose of the passive loss rules to prevent sheltering of income from personal services and portfolio income with passive losses. Moreover, the regulations should attempt to avoid inconsistent allocation of interest deductions under different Code provisions [*e.g.*, an interest deduction that is disallowed under §265 or §291 should not be allowed, capitalized, or suspended under another provision]." [80]

The Conference Report further notes that "[i]n the case of entities, a proper method of allocation may include

[74] *Id.*, at II-145.

[75] §469(e)(1)(A)(i). Note that §469(e)(4) provides, for purposes of paragraph (1), that "income from dividends shall be reduced by the amount of any dividends received deduction under §§243, 244, or 245."

[76] In this regard, the Conference Report makes clear that REIT dividends, income received from a RIC or a real estate mortgage investment conduit (REMIC) are treated as portfolio income. Conference Report at II-146, footnote 3.

[77] Working capital generally includes amounts set aside for the reasonable needs of the business.

[78] Conference Report at II-146-47.

[79] *Id.* at II-147.

[80] *Id.* at II-146.

for example, allocation of interest to portfolio income on the basis of assets, although there may be situations in which tracing is appropriate because of the integrated nature of the transactions involved. Because of the difficulty of recordkeeping that would be required were interest expense of individuals allocated rather than traced, it is anticipated that, in the case of individuals, interest expense generally will be traced to the asset or activity which is purchased or carried by incurring or continuing the underlying indebtedness." [81]

Note: In Announcement 87-4, released on December 31, 1986, the Service stated that temporary regulations to be issued will generally provide that, for purposes of the investment interest rules of §163(d), the personal interest rules of §163(h), and the §469 passive activity rules, interest expense (other than qualified residence interest) will be allocated on the basis of the use of debt proceeds - *i.e.*, a tracing approach. For example, interest on debt used to purchase an interest in a passive activity will be taken into account in the computation of passive activity income and loss. The temporary regulations will further clarify that interest on debt incurred to purchase a partnership interest or S corporation stock will be treated as trade or business interest if the assets of the partnership or S corporation are used solely in the conduct of a trade or business. If the taxpayer holding the partnership interest or S corporation stock does not materially participate in the trade or business conducted by the entity, the interest on the acquisition debt will be taken into account in computing the taxpayer's income or loss from the passive activity.

The conferees clearly recognized that the fact that both portfolio and other activities are conducted within the same entity does not allow them to be combined so that the portfolio portion must still be separated. For example, a partnership engaged in a business that invests excess capital in interest-bearing securities will have both business and portfolio allocations to its partners. By the same token, the taxpayer's return on capital invested in an entity can be treated as a portfolio investment even though the funds are actually used by the entity for other purposes. If the investment is in the form of a loan, the return on the loan will normally be portfolio income. A capital contribution, on the other hand, could generate business or other non-portfolio income or loss.

4. *Regulatory Authority of Treasury in Defining Non-Passive Income*

Section 469(k)(2) requires the Treasury to issue regulations with regard to the definition of income that is treated as portfolio income or as otherwise not arising from a passive activity. The Conference Report states that "[t]he conferees intend that this authority be exercised to protect the underlying purpose of the passive loss provision, i.e., preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities." [82]

The Conference Report provides the following key examples where the exercise of such authority may be appropriate: "(1) ground rents that produce income without significant expenses, (2) related party leases or sub-leases, with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income; and (3) activities previously generating active business losses that the taxpayer intentionally seeks to treat as passive at a time when they generate net income, with the purpose of circumventing the rule." [83]

D. Working Interests in Oil and Gas Property

Section 469(c)(3)(A) provides that "[t]he term 'passive activity' shall not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest." Thus, losses and credits derived from such interests can be used to offset other income of the taxpayer without limitation under the passive loss rule.[84]

The Senate Report states that "a working interest is an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property. Rights to overriding royalties, production payments, and the like, do not constitute working interests, because they are not burdened with the responsibility to share expenses of drilling, completing, or operating oil and gas property. Similarly, contract rights to extract or share in oil and gas, or in profits from extraction, without liability to share in the costs of production, do not constitute working interests. Income from such interests generally is considered to be portfolio income." [85]

The Senate Report further clarifies that "[a] working interest generally has characteristics such as responsibility for signing authorizations for expenditures with respect to the activity, receiving periodic drilling and completion reports, receiving periodic reports regarding the amount of oil extracted, possession of voting rights proportionate to the percentage of the working interest possessed by the taxpayer, the right to continue activities if the present operator decides to discontinue operations, a proportionate share of tort liability with respect to the property (*e.g.*, if a well catches fire), and some responsibility to share in further costs with respect to the property in the event that a decision is made to spend more than amounts already contributed." [86] That a taxpayer is entitled to decline, or does decline, to make additional contributions under a buyout, nonparticipation, or similar arrangement, or that tort liability may be insured against does not contradict such taxpayer's possessing a working interest.[87]

If the liability of the taxpayer is limited, such as through a limited partnership or S corporation, the interest possessed by such taxpayer is not a working interest for purposes of the statute. The Senate Report points out that "[t]he same result follows with respect to any form of ownership that is substantially equivalent in its effect on liability to a limited partnership interest or interest in an S

[81] *Id.*
[82] *Id.* at II-147.
[83] *Id.*
[84] Senate Report at 744.
[85] *Id.*
[86] *Id.*
[87] *Id.* at 745.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

corporation, even if different in form. The rule is applied by looking through tiered entities." [88]

A special rule applies in any case where, for a prior taxable year, net losses from a working interest in a property were treated by the taxpayer as not from a passive activity. In such a case, §469(c)(3)(B) provides that "any net income from such property (or any property the basis of which is determined in whole or in part by reference to the basis of such property) for any succeeding taxable year shall be treated as income of the taxpayer which is not from a passive activity."

Example: Taxpayer X claims nonpassive losses for a year with regard to a working interest in an oil property. After the property begins to generate net income, X transfers his working interest to an S corporation in which he is a shareholder. X's interest with regard to the oil property will continue to be treated as not passive.

The Senate Report cautions that "[u]nder some circumstances, deductions relating to a working interest may be subject to limitation under other provisions in the Internal Revenue Code. For example, protection against loss through nonrecourse financing, guarantees, stop-loss agreements or other similar arrangements, may cause certain deductions allocable to the taxpayer to be disallowed under §465. Such limitations are applied prior to and independently of the passive loss rule." [89]

E. Effective Date and Transition Rules

1. Effective Date

In general, the new limitations on losses and credits from passive activities apply to passive activity losses incurred in tax years beginning after 1986 and to passive activity credits attributable to property placed in service in those same years.[90] Under a special rule for carryovers, the new limitations do not apply to any loss, deduction or credit carried to a taxable year beginning after December 31, 1986, from a taxable year beginning before January 1, 1987.[91]

2. Transition Rule

a. General

Section 469(l) applies a special phase-in rule (for the regular tax but not the alternative minimum tax) in the case of any passive activity loss or credit for any taxable year beginning in calendar years 1987 through 1990 which is (i) attributable to a "pre-enactment interest" but (ii) not attributable to a carryforward to such taxable year of any loss or credit which was disallowed under §469 for a preceding taxable year. Under this phase-in rule, a percentage of losses from "pre-enactment interests" is made subject to the passive loss limitation in accordance with the following table:

Taxable Years Beginning In	Percentage of Losses Subject to Limitation
1987	35%
1988	60%
1989	80%
1990	90%

b. Pre-enactment Interests

Section 469(l)(3)(B)(i) defines "pre-enactment interest" as "any interest in a passive activity held by a taxpayer on the date of the enactment of the Tax Reform Act of 1986, and at all times thereafter."

Example: Assume Taxpayer X, who has interests in no other passive activities, bought a limited partnership interest in an apartment project on October 22, 1986 (the day of enactment). Assume, further, that X's net passive activity loss from the apartment project is $10,000 for his 1987 taxable year. X would be able to deduct, without limitation, $6,500 of the loss. The remaining $3,500 would be subject to the passive activity loss limitation.

Section 469(l)(3)(B)(ii) provides that a contractual obligation to purchase an interest in a passive activity that is binding on the date of enactment and at all times thereafter shall be treated as an acquisition of the interest in the activity. The Conference Report states that "[a] binding contract qualifies under this rule, even if the taxpayer's obligation to acquire an interest is subject to contingencies, so long as the contingencies are beyond the reasonable control of the taxpayer.[92]

The Conference Report clarifies that if investors contribute additional capital to an activity after October 22, 1986, their interests will still qualify for full relief under the phase-in to the extent that their percentage ownership interests do not change as a result of the contribution. However, if a taxpayer's ownership interest increases after October 22, 1986, then (except to the extent the increase arises pursuant to a pre-enactment binding contract or partnership agreement), the portion of his interest attributable to the increase will not qualify for phase-in relief.[93]

Section 469(l)(B)(iii) provides that, as a general matter, in order to qualify for transition relief, the interest acquired by a taxpayer must be in an activity which has commenced by October 22, 1986. For example, a rental activity commences when the rental property has been placed in service in the activity. The Conference Report provides in this regard that "[w]hen an entity in which the taxpayer owns an interest liquidates or disposes of one activity and commences another after the date of enactment, the new activity does not qualify for transition relief. In the case of property purchased for personal use but converted to business use (e.g., a home that the taxpayer converts to rental use), similar rules apply." [94]

Section 469(l)(B)(iii) further provides that in the case of an activity that has not commenced by October 22, 1986,

[88] *Id.*
[89] *Id.*
[90] Act §501(c)(1).
[91] Act §501(c)(2).
[92] Conference Report at II-148-49.
[93] *Id.* at II-149.
[94] *Id.*

phase-in relief nevertheless applies if the entity (or an individual owning the activity) has entered into a written binding contract in effect August 16, 1986 and all times thereafter, to acquire the assets used to conduct the activity. Likewise, phase-in relief applies in the case of self-constructed business property where construction of the property to be used in the activity has commenced on or before August 16, 1986.

c. Portion of Loss or Credit Eligible for Phase-in

The conferees understood that during the phase-in period, a taxpayer might own both pre-enactment and post-enactment interests in passive activities. Therefore, they provided clarification regarding the calculation of the amount of passive loss qualifying for the phase-in. Pursuant to §469(l)(3)(A), it is first necessary to determine the amount of passive loss that would be disallowed absent the phase-in. Phase-in relief then applies to the lesser of the taxpayer's total passive loss, or the passive loss taking into account only pre-enactment interests.

Example: Taxpayer X has $500 of passive loss relating to pre-enactment interests which would be disallowed in the absence of the phase-in rule. X also has $200 of net passive income from post-enactment interests. The total passive loss, therefore, is $300. Thus, the phase-in treatment applies to $300 (*i.e.* the lesser of $500 or $300). *See* Conference Report at II-149-150.

For purposes of this rule, the pre-enactment and post-enactment losses are calculated by including credits, in a deduction equivalent sense.

d. Passive Loss and Credit Carryforwards During Phase-in Period

Under the Conference Agreement, any passive loss that is disallowed for a taxable year during the phase-in period and carried forward is allowable in a subsequent year only to the extent that there is net passive income in the subsequent year (or there is a fully taxable disposition of the activity). Conference Report at II-150.

Example: Taxpayer S has a passive loss of $100 in 1987, $65 of which is allowed under the applicable phase-in percentage for the year and $35 of which is carried forward. Such $35 is not allowed in part in a subsequent year under the phase-in percentage applying for such year. If X has a passive loss of $35 in 1988, including the amount carried over from 1987, then no relief under the phase-in is provided. If X has a passive loss of $50 in 1988 (consisting of $35 from 1987 and $15 from 1988, all of which is attributable to pre-enactment interests), then $6 of losses (40% of the $15 arising in 1988) is allowed against active income under the phase-in rule. The $35 loss carryover from 1987 is disallowed in 1988 and is carried forward (along with the disallowed $9 from 1988) and allowed in any subsequent year in which the taxpayer has net passive income. *See* Conference Report at II-150.

e. Application to $25,000 Allowance

The applicable phase-in percentage for any transition year applies to the passive loss net of any portion of such loss that may be allowed against nonpassive income under the $25,000 loss allowance for active participants in rental real estate activities. Conference Report at II-150. In other words, the $25,000 exception is applied to the aggregate net passive losses before phase-in and not to the remaining nonutilized losses after the phase-in calculation.

f. Application of the Alternative Minimum Tax

Section 701 of the TRA 1986 revises the alternative minimum tax for individuals and corporations. With respect to individuals, Act §701 adds, *inter alia*, new Code §58(b) which provides that, in computing the alternative minimum taxable income of the taxpayer for the taxable year, §469 shall apply, except that * * * §469(l) (relating to the phase-in) shall not apply.

g. Qualified Low Income Housing Projects

Act §502 provides that any loss sustained by a "qualified investor" with respect to an interest in a "qualified low-income housing project" — a project constructed or acquired pursuant to pre-August 16, 1986 contracts — for any taxable year in the "relief period" shall not be treated as a loss from a passive activity for purposes of §469.

Although the phase-in of the disallowance of the passive loss limitation does not apply for alternative minimum tax purposes, it appears that the transition rule for qualified low-income housing is applicable. Under Act §502, a qualified investor's interest in a qualified low-income housing project for any taxable year in the relief period is not treated as a passive loss for purposes of §469. Accordingly, when new §58 states that §469 shall apply in computing the alternative minimum tax, losses from interests in the low-income housing projects described in Act §502 appear to be excluded from the alternative minimum tax calculation since they are not treated as §469 losses.

The legislative history to the Act is silent as to whether Congress intended to exclude losses with respect to interests in such low-income housing projects from the calculation of the alternative minimum tax. However, the fact that Congress expressly did not apply the phase-in of the passive loss limitation may be evidence that its failure to make similar provision for Act §502 was intentional.

III. Implications

A. The Established Developer versus the New, Inexperienced Developer

The enactment of the passive loss rule has shifted the focus of real estate investment from real estate as a tax shelter to real estate as a source of income. A prime example of income-oriented real estate is a fully-leased, nonresidential building whose tenants have entered long term (at least 10 years) leases at market rents. Under the passive loss rule, such a building will be particularly attractive to investors with heavy tax losses from previous passive investments made under pre-1986 TRA law which permitted such losses to be fully applied against one's income — whatever its source. If such investors could purchase an interest in the building, with a share of the rent stream, they could offset their tax losses from their other passive investments with the income derived from their interest in the building.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Two obvious questions arise: (1) who currently owns such buildings, and (2) why would such owners be interested in selling these buildings? As a rule, developers who have established reputations for building quality buildings will be better able to lease up their buildings than newer developers. Accordingly, with respect to the first question, income-oriented real estate generally will be owned by established developers in their own right or by limited partnerships with an established developer/general partner. Many such developers are C corporations which traditionally have sought to maximize income rather than tax losses from real estate projects they own.

Regardless of the form in which a developer participates in the ownership of an income-oriented building, a developer usually needs capital for future construction. Current law encourages the developer to borrow money to fund such construction, often using proceeds from refinancing the debt secured by an income-producing building. However, the passive loss rule, together with the broadened at-risk rule and investment interest limitation, discourage such borrowing. Thus, in answer to the second question, the developer may wish to sell interests in his building to raise capital.

If a developer sells interests in his building, in what form will they be marketed? One form of investment would be a limited partnership interest. The return to the limited partners would be the rent from the tenants. The price charged for such limited partnership interests will be a function of the anticipated return. The more financially secure the tenant, the greater the price for the limited partnership interest. In other words, the limited partnership interests could have ratings similar to those for REITs or collateralized mortgage obligations (CMOs). The advantage of the limited partnership structure over REITs or CMOs is its flexibility. Unlike a limited partnership, REITs and CMO trusts have little control over the management of the underlying real estate. Moreover, developers who currently participate in their buildings as general partners in limited partnerships would not have to change the form of ownership of such buildings. Instead they could simply restructure the existing partnerships to emphasize income, rather than loss, generation and to provide for allocation of most or all rental income to existing and incoming limited partners.

Thus, the passive loss rule could benefit the established developers but hinder the ability of newer developers to raise capital. Since the passage of the Economic Recovery Tax Act of 1981, the limited partnership real estate tax shelter has been a primary means of financing development. The lure of tax losses (interest and ACRS deductions) encouraged investment in such partnerships. New, often inexperienced developers, entered the real estate field by means of syndicating limited partnerships, resulting in gross overbuilding.

The passive loss rule takes dead aim at such developers. Under the rule, limited partners who purchased their interests with deferred purchase money notes will not be able to finance their installment payments with the tax savings arising from the application of losses generated by their investment against their incomes. Many limited partners will default on their notes. As a result, developers will be forced to sue these limited partners. While these suits are pending, the developers will lack a major source of capital. Moreover, they may never recover the full amount of the notes. When coupled with the inadequacy of rental income to service the debt on the buildings owned by these partnerships, this loss of capital could lead to foreclosure.

Of course, established developers are aware of the problems the newer developers will face under the passive loss rule. As noted above, many of these developers are C corporations who traditionally have undertaken income-oriented projects. These developers can use losses from troubled projects owned by the real estate tax shelter limited partnerships syndicated by the newer developers. Accordingly, they can be expected to be eager buyers of these projects. This point was not lost on the Finance Committee, which estimated that corporate taxes could decline by $12.7 billion as a result of the enactment of the passive loss rule.

B. The Developer Who Engages in Rental Activity and Sales Activity; Structuring Real Estate Ownership

Cognizant that real estate limited partnerships engaged in rental activity have been a primary source of tax avoidance, Congress determined that all rental activity should be treated as an intrinsically passive activity regardless of whether one materially participates in the rental activity. Critics of this aspect of the passive loss rule argue that by treating rental activity as passive *per se*, the Act unfairly penalizes taxpayers who engage in rental activity as part of their trade or business. Indeed, a good argument can be made that the material participation standard is strong enough to weed out taxpayers who invest in rental activity solely for tax avoidance purposes from those who engage in rental activity as part of their trade or business.

Regardless of the merits of these arguments, the passive loss rule itself suggests that taxpayers who engage in rental activity as part of their trade or business can avoid the rule by operating through a closely held C corporation. As mentioned earlier, a closely held C corporation (other than a personal service corporation) may offset active income with passive losses. Thus, a taxpayer who both sells and rents houses can offset the income from the sales of the houses with any excess losses from the rental activity, if he engages in such activities through a closely held corporation. Conversely, if a taxpayer engages in such activities in his individual capacity or through an S corporation, partnership or personal service corporation, he cannot apply the rental losses against sales income.

Therefore, a closely held C corporation may be the best manner in which to engage in rental activity as a trade or business if one has substantial active income from another trade or business. This is so despite the new corporate minimum tax. The minimum tax plan requires a corporation to compute its tax twice — once under the regular tax and once under the minimum tax — and pay whichever is higher. The minimum tax would be calculated at at a 20% rate, but would eliminate many of the tax losses allowed under the regular tax.

The only significant tax preference associated with rental real estate included in the minimum tax base, however, would be the so-called "alternative depreciation" de-

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

fined as straight-line depreciation over 40 years. In view of the fact that the Act already stretches the life of residential real estate to 27.5 years and nonresidential real estate to 31.5 years, with the cost of both types of property to be recovered using the straight-line method of depreciation, the additional tax resulting from the taxation of such "alternative depreciation" should not significantly reduce the amount of the offset of excess passive losses from rental activity against active income.

C. Intentionally Failing the Material Participation Standard

The strict definition of material participation opens up significant potential for arranging a taxpayer's business affairs such that the he will not materially participate in an activity that can generate substantial income to the taxpayer. For example, if a builder/developer owns a management company producing net income in which he does not materially participate, the income from the business will be passive and, therefore, eligible to be offset by other passive losses. Although Treasury has broad regulatory authority to limit the efficacy of this strategy, it would appear anomalous to make the material participation test very strict for activities generating losses but not so strict for activities generating income.

D. Dispositions Where Suspended Losses From Activity Exceed Potential Gain

In situations where the accumulated losses from a passive activity exceed the potential gain from its sale (particularly where the activity has declined in value) or where a major portion of the gain will have to be recognized in any event, taxpayers should dispose of their interest in the activity and claim the suspended losses. In this regard, taxpayers should make certain that they meet the criteria for a complete and fully taxable disposition. Otherwise, the accumulated losses may continue to be suspended and produce no current tax benefit.

E. The Regulations Caveat

No matter what planning advice is given with respect to the limitations on losses and credits from passive activities, one should remember that Congress gave Treasury extensive regulatory authority to preserve the underlying purpose of the limitations: to prevent the sheltering of positive income sources through the use of tax losses derived from passive business activities.

For another discussion of the new passive loss rules, *see* Madden, "The Passive Loss Rules: A New Day for Real Estate," 2 *Tax Mgmt. Real Est. J.* 264 (Dec. 1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 18

MODIFICATION OF INSTALLMENT SALES RULES *

Donald B. Reynolds, Jr., Esq.
Silverstein and Mullens
Washington, D.C.

I. New Restrictions on Installment Sales

A. Introduction

Under the 1954 Code, a taxpayer who disposed of certain types of property in exchange for the purchaser's obligation to make deferred payments (*i.e.*, an "installment obligation") generally recognized the gain on the disposition in the years in which the deferred payments were received. Following the enactment of the Installment Sales Revision Act of 1980, virtually all deferred payment sales qualified for the installment method of accounting. A taxpayer disposing of property in a transaction that qualified under the installment method, however, could always "elect out" of the installment method and recognize gain on the transaction in accordance with its regular accounting method.

Under the pre-TRA 1986 rules, the following three types of transactions qualified for the installment method:

(1) Regular sales or dispositions of personal property (*i.e.*, inventory) by a dealer on an installment plan or on certain revolving credit plans (§453A);

(2) Sales or other dispositions of real property where at least one payment is to be received in a year following the year of sale; and

(3) Casual sales or other dispositions of personal property (*i.e.*, non-inventory property) where at least one payment is to be received in a year following the year of sale.

Comment: Regs. §1.453-2(d)(1) defines a "revolving credit plan" to include cycle budget accounts, flexible budget accounts, continuous budget accounts, and other similar plans or arrangements for the sale of personal property where the customer agrees to pay each billing month a part of the outstanding balance on his account.

Under the installment method, the taxpayer reports gain as he receives the installment payments. Under §453(c), the gain recognized by the taxpayer is equal to: (1) the gross profit which the taxpayer recognizes on the entire sale divided by the total contract price; multiplied by (2) the payments received in that year. For purposes of computing the taxpayer's gain under this rule, payments are deemed to include cash, other property, marketable securities, assumptions of certain liabilities and evidences of indebtedness of the purchaser that are payable on demand or are readily tradeable. Thus, the installment method fulfilled its underlying legislative purpose by deferring tax on a seller's gain until the seller had sufficient liquidity or financial wherewithal to pay the liability.

Comment: For a detailed analysis of the the pre-TRA 1986 rules applicable to installment sales, *see* 48 T.M., *Installment Sales*.

Upon the disposition of an installment obligation, the seller recognizes gain or loss under §453B(a) equal to either (i) the difference between the amount realized and the basis of the obligation, in a case where the obligation is satisfied at other than face value or is sold or exchanged, or (ii) the difference between the fair market value of the obligation at the time of disposition and its basis, in the case of distribution, transmission or disposition other than by sale or exchange. The basis of an obligation is equal to the excess of its face value over the amount of income that would be recognized if the obligation were satisfied at its face amount. §453B(b).

A disposition of an installment obligation may arise in a variety of ways. For example, a disposition can arise when a corporation distributes an installment obligation to its shareholders. A number of cases also considered the question of whether a pledge of an installment obligation constituted a disposition.[1] In these decisions, the courts applied a facts and circumstances test to determine whether the pledge of an installment obligation as collateral for a loan should be treated as a disposition of the obligation. Basically, as long as the taxpayer retained sufficient economic benefits and burdens of ownership with respect to the installment obligation and the pledge of the installment obligation occurred in connection with a bona fide loan, the taxpayer had a good chance of establishing that the loan did not constitute a disposition.

Homebuilders and other real estate developers devised a financing technique known as "builder bonds," through which sellers of real estate were able to report their gain, for tax purposes, under the installment sales method and, at the same time, by pledging installment obligations, realize

* The author wishes to acknowledge the contribution of Joseph P. Giljum, who prepared the examples incorporated in Section I, C, 1, a. Mr. Giljum is the author of 48 T.M., *Installment Sales*.

[1] *See, e.g., United Surgical Steel Co. v. Comr.*, 54 T.C. 1215 (1970), acq., 1971-2 C.B. 3; *Town & Country Food Co., Inc. v. Comr.*, 51 T.C. 1049 (1969), acq., 1969-2 C.B. xxv.

a large portion of their sales price in cash immediately following the sales transactions. For example, in a simple case, a homebuilder could finance the sale of his inventory by accepting mortgage notes from the purchasers and then "cash out" a large portion of the principal amount of the notes by pledging them as security for a long-term loan from an independent lender. The IRS sanctioned this basic technique in a number of private letter rulings.[2]

After several earlier efforts by the Treasury to propose legislation which would preclude the use of builder bonds, the House of Representatives included in its version of H.R. 3838 a provision which would have severely restricted the ability of taxpayers to continue to report income under the installment method after pledging installment obligations. Basically, the House concluded that a taxpayer who pledged installment obligations was economically in the same position as a taxpayer who sold property for cash. Thus, the House believed that pledges of installment obligations ran contrary to the original purpose of the installment method [deferring the tax liability of a seller in a case where the seller did not have the wherewithal to pay its taxes because it received illiquid installment obligations in the sales transaction].

To correct this perceived incongruity, the House version of H.R. 3838 generally would have treated the pledge of an installment obligation as collateral for a loan as a disposition. Thus, the proceeds of the loan would have been treated as a payment on the underlying installment obligation, thereby giving rise to immediate gain.[3]

Whereas the House of Representatives focused on the specific issue of pledges of installment obligations, the Senate opted for a much broader revision of the installment method rules. First, the Senate determined that the installment sales method was inappropriate in the case of gains realized by dealers who sold inventory under a revolving credit plan. Moreover, the Senate took a similar view of sales of publicly-traded property and concluded that such sales should not be eligible for the installment method. Finally, the Senate indicated that with respect to sales of other business or rental property, the installment method should not be available "to the extent that the taxpayer has been able to receive cash from borrowings related to its installment obligations." [4] The Senate, however, adopted a more expansive view than the House in determining which loan proceeds of a taxpayer are "related" to its installment obligations. That is, the Senate concluded that debt other than debt secured by pledges of specific installment obligations should give rise to an acceleration of a taxpayer's gain that otherwise would be deferred under the installment method. In this regard, the Senate Report noted that:

> "The committee believes that the borrowings of a taxpayer generally are related to its installment obligations in one of two ways. In general, either the taxpayer would not undertake all or a portion of the borrowings but for its extending credit in connection with the sale of its property or the taxpayer's borrowing ability is enhanced by the presence of the installment obligation among the taxpayer's assets. The committee recognizes, however, that it is extremely difficult to determine with any precision the extent of the nexus between the taxpayer's borrowings and its installment obligations. Hence, the committee believes it appropriate to adopt a rule which assumes that the borrowings of the taxpayer may be allocated among the taxpayer's assets on a pro rata basis . . . .
>
> "The committee recognizes that arguments may be made that, in certain circumstances, a taxpayer's borrowings may appear to have no nexus whatsoever to its installment obligations, and that in other circumstances, a taxpayer's borrowings may appear to be so closely related to its installment obligations that the installment obligations could appropriately be treated as having been disposed of. Nevertheless, rather than making necessary the difficult and subjective inquiry regarding the nexus between the borrowings of a taxpayer and its installment obligations, the committee believes that imposing a limitation based on a pro rata allocation of the taxpayer's borrowings is an appropriate accommodation of competing concerns." [5] [Footnote omitted.]

In order to accomplish its objective of defining those borrowings of a taxpayer that are related to its installment obligations, the Senate adopted a complicated "proportionate disallowance rule" which treats a portion of the outstanding indebtedness of a taxpayer as a payment against the taxpayer's installment obligations. Thus, the Senate opted for a much more comprehensive revision of the installment sales method and enacted restrictions that will affect an extremely broad segment of taxpayers who utilize the installment method.

B. Overview

TRA 1986 significantly restricted the availability of the installment sales method of accounting. Specifically, the changes enacted in the Act preclude dealers in personal property from using the installment method with respect to sales under a revolving credit plan. Further, sales of publicly traded property are no longer eligible for the installment method. Finally, the Act included provisions limiting the availability of the installment method with respect to sales of real or personal property that constitutes inventory, as well as sales of business or rental real estate.

C. Detailed Analysis

1. Proportionate Disallowance Rule

As noted above, under pre-TRA 1986 law, a taxpayer could borrow against its installment obligations without adversely affecting its ability to report gain under the installment method, so long as the taxpayer did not pledge

[2] *See, e.g.*, PLR 8149041.

[3] Section 903 of the House version of H.R. 3838 would have added a new §453C entitled "Pledges, Etc., of Installment Obligations." It provided an exception from the disposition rule for pledges of obligations in connection with short-term loans payable within 90 days. The Bill also provided that loan proceeds would not be treated as a payment against an underlying installment obligation to the extent that a portion of the obligation was payable within 9 months of the date on which it arose. For a description of the House bill, see H.R. Rep. No. 426, 99th Cong., 1st Sess. 609-15 (1985).

[4] S. Rep. No. 313, 99th Cong., 2d Sess. 123 (1986) (hereafter cited as "Senate Report").

[5] Senate Report at 123-24.

the obligations as collateral in a manner that resulted in a "disposition." In contrast, under the new "proportionate disallowance rule," the existence of any outstanding borrowings by the taxpayer will give rise to a deemed payment with respect to a number of different types of installment obligations.

The proportionate disallowance rule limits the amount of a sale which qualifies for the installment method in the case of obligations arising out of (i) sales of personal property by dealers (*i.e.*, inventory) under the installment plan,[6] (ii) sales of real property by dealers,[7] and (iii) sales of real property used in the taxpayer's trade or business or held for the production of rental income, but only if the sales price for such property exceeds $150,000.[8]

Comment: TRA 1986 does not limit the use of the installment method with respect to obligations arising from an individual's sale of personal use property or property used or produced in the trade or business of farming.[9]

a. Allocable Installment Indebtedness

In order to apply the proportionate disallowance rule, a taxpayer must first determine the amount of its "allocable installment indebtedness" ("AII") for each taxable year. AII is treated as a payment, immediately before the close of the taxable year, on "applicable installment obligations" that arose during that taxable year and that are still outstanding at the end of the taxable year.[10] The effect of this rule is to treat a portion of the taxpayer's debt as a payment toward his installment obligations, thereby accelerating a portion of the gain that otherwise would have been deferred under the installment method.

In computing AII, one must first determine the "installment percentage," which is the face amount of the taxpayer's "applicable installment obligations" (defined below) outstanding at the end of the taxable year divided by the sum of (i) the face amount of its installment obligations outstanding at that time and (ii) the adjusted basis of all its other assets.[11] The installment percentage is multiplied by the taxpayer's average quarterly indebtedness for the taxable year; from that amount, subtract the AII attributable to applicable installment obligations arising in previous years, but still outstanding at the end of the current taxable year.[12] In making these calculations, individual taxpayers must exclude assets that are personal use property within the meaning of §1275(b)(3) (including installment obligations arising from the sale of such property) from the installment percentage; in calculating average quarterly indebtedness, individuals must exclude indebtedness substantially all the security for which is personal use property.[13]

"Applicable installment obligations" include any installment obligations held by the seller or a member of its affiliated group that arise from the sale, after February 28, 1986, of (i) personal property on the installment plan by a dealer in personal property or (ii) real property held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.[14] The term also includes installment obligations that arise from the sale, after August 16, 1986, of real property used in the taxpayer's trade or business or held for the production of rental income, *provided that the selling price of the property exceeds $150,000.*

Comment: TRA 1986 authorizes the Treasury to issue regulations that require all (or any portion) of the taxpayer's applicable installment obligations to be aggregated as a single obligation. §453C(e)(3). It appears that Congress included this provision in §453C to prevent taxpayers from circumventing the $150,000 ceiling by fragmenting a sale into a number of smaller (but interdependent) transactions.[15] A similar rule is incorporated in §1274(c)(3)(A)(ii), which exempts from the original issue discount rules, sales of certain farms for less than $1,000,000.

New §453C(c)(1) provides that in each subsequent taxable year, the taxpayer is not required to recognize gain attributable to applicable installment obligations arising in any prior year to the extent that payments on the obligations do not exceed the AII attributable to such obligations. Payments in excess of the AII will be accounted for and taxed in accordance with the normal installment sales rules, *i.e.*, based on the gross profit percentage.

The basic rules for calculating AII may be illustrated perhaps more clearly in the following manner:

Step 1. Determine the face amount of those obligations (to which the proportionate disallowance rule applies) which are outstanding at the end of that year.

Step 2. Determine the face amount of *all* installment obligations (both those to which the proportionate disallowance rule applies as well as all other installment obligations) which are outstanding at the end of that year.

Step 3. Determine the adjusted basis of all assets of the taxpayer, other than installment obligations, held as of the end of that year.

Step 4. Determine the average quarterly indebtedness of the taxpayer for that year.

Step 5. Divide *Step 1* by the sum of *Step 2* and *Step 3.* [This is the installment percentage.]

Step 6. Multiply the result (quotient) determined in *Step 5* by the amount determined in *Step 4.*

Step 7. Subtract any AII that is attributable to applicable installment obligations arising in previous years that are outstanding at the end of the taxable year.

[6] §453C(e)(1)(A)(i)(I). Section 811 of TRA 1986 added a new §453C to Code, which sets forth the proportionate disallowance rule. Act §812 added a new §453(j) to deny the use of the installment method with respect to obligations arising from sales under a revolving credit plan or sales of readily traded property. In this chapter, all references to the provisions enacted by TRA 1986 are cited by reference to the new Code sections, as amended.

[7] §453C(e)(1)(A)(i)(II).

[8] §453C(e)(1)(A)(i)(III).

[9] §453C(e)(1)(B).

[10] §453C(a).

[11] §453C(b)(2).

[12] §453C(b)(1).

[13] §453C(b)(3).

[14] §453C(e)(1).

[15] *See* H.R. Rep. No. 841, 99th Cong., 2d Sess. II-295 (1986) (hereafter cited as "Conference Report).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Example: Assume the following facts: The taxpayer has $100,000 in face amount of installment obligations (to which the proportionate disallowance rule is applicable) which are outstanding at the end of that taxable year (*Step 1*). The face amount of all installment obligations outstanding at the end of the taxable year amounts to $200,000 (*Step 2*). The adjusted basis of all other assets of the taxpayer amounts to $200,000 (*Step 3*). The average quarterly indebtedness of the taxpayer outstanding for the year amounts to $200,000 (*Step 4*). Divide $100,000 (*Step 1*) by $400,000 (the sum of *Step 2* and *Step 3* [$200,000 + $200,000]), which results in a quotient of ¼, or 25% (*Step 5*). The $200,000 average quarterly indebtedness of the taxpayer (*Step 4*) is then multiplied by the quotient (25%), the result being $50,000 (*Step 6*). Assuming that there was no AII in a previous year (*Step 7*), the amount treated as a payment as of the end of the taxable year is $50,000. The amount of gain, of course, would depend upon the gross profit ratio for such year.

Comment: In view of the limited exemption for sales of dealer and rental real estate (*i.e.*, sales of less than $150,000), the proportionate disallowance rule can be expected to have a significant impact on real estate transactions. This result is all the more likely given the traditional reliance of real estate purchasers on various forms of seller financing. Owners of real estate also may find that their tax planning under the new passive loss rules runs at cross purposes with the proportionate disallowance rule. For example, all other things being equal, a taxpayer might conclude that it is beneficial, under the passive loss rules, to convert inactive real estate into rent producing property that generates "passive" rental income that can be offset by other "passive" real estate losses. Such a conversion, however, would cause any installment obligations received by the owner on an ultimate sale to be subject to the proportionate disallowance rule since the property would constitute property held for the production of rental income under §453C(e)(1). Alternatively, if the real estate generated no rental income while owned by the taxpayer and was sold in a raw, undeveloped state, the taxpayer could argue that the property was not used in a trade or business or held for the production of rental income. Under this theory, any installment obligations received in a sale would not qualify as "applicable installment obligations," and the taxpayer might be able to avoid the consequences of the proportionate disallowance rule.

b. Outstanding Debt

As noted above, to calculate AII, a taxpayer must compute its average indebtedness for the year. Generally, the calculation is made on a quarterly basis.[16] However, if a taxpayer has no applicable installment obligations that arose from the regular sale of personal property on the installment plan or from sales of real property in the ordinary course of business, it will calculate its average annual indebtedness at the close of its taxable year, rather than on a quarterly basis.[17] In calculating its outstanding indebtedness, a taxpayer is to determine all indebtedness outstanding at the end of the measuring period, including accounts payable and accrued expenses, as well as other amounts more commonly considered as indebtedness, such as bank loans, bonds or indebtedness arising from the purchase of property.[18]

Taxpayers may have the ability to reduce the amount of debt immediately prior to the date on which it is calculated (whether on a quarterly or annual basis) by paying accrued expenses and "similar items" that would be included in the principal amount of outstanding debt under the principles described above. The Senate Report stipulates that any payments made in such circumstances in order to reduce outstanding indebtedness are to be ignored in making the calculation called for by §453C(b).[19]

Comment: The Senate Report only specifically refers to attempts by taxpayers to reduce their outstanding indebtedness through last minute payments of accrued expenses and "similar items"; it is unclear how similarly motivated repayments of loan principal will be viewed. (Taxpayers required to calculate their indebtedness on a quarterly basis would presumably have little opportunity for this type of manipulation.) In an analogous situation, Congress has acted to prevent year-end loan repayments from reducing an exempt organization's "acquisition indebtedness" for purposes of the tax on unrelated debt-financed income. Thus, under these rules, an exempt organization is required to calculate its acquisition indebtedness on a monthly basis. *See* §514(c)(7); Regs. §1.514(a)-1(a)(3). Since Congress failed to include this type of averaging mechanism to preclude year-end loan repayments, it can be argued that such repayments by taxpayers required to calculate their indebtedness under §453C(b)(4) should be respected for purposes of the proportionate disallowance rule.

In calculating the amount of a taxpayer's indebtedness, §453C incorporates the principles of §§483 and 1274.[20] Thus, if, under these provisions, a portion of the principal of a debt is recharacterized as interest because the debt fails to bear the appropriate interest rate, the reduced amount of principal will count as outstanding debt for purposes of the proportionate disallowance rules.

c. Special Rules Applicable to Affiliated Groups and other Related Parties

Under §453C(e)(2), all persons treated as a single employer under §52 shall be treated as one person for purposes of the proportionate disallowance rule. The section also authorizes the Treasury to issue regulations for the treatment of transactions between such persons. The legislative history of TRA 1986 indicates that, under these regulations, the related entities will be treated as a single taxpayer and each affiliated member is to be treated as having the assets and liabilities of every other member.[21] Indebtedness between members of the group, other than applicable installment obligations, will be disregarded, how-

[16] §453C(b)(1)(A).
[17] §453C(b)(4).
[18] Senate Report, at 126.
[19] Senate Report, at 126-27. The Conference Report, at II-298, authorizes the Treasury to issue regulations preventing avoidance of this provision where the calculation is made on an annual basis.
[20] Senate Report at 126-27, footnote 6.
[21] Senate Report at 127.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ever. Also, the adjusted basis of any asset transferred from one member of the group to another will be reduced by the amount of the gain which has not been recognized or otherwise has been deferred either under Regs. §1.1504-13 or because the gain was eligible to be reported on the installment method. The AII computed for the affiliated group is to be allocated pro rata to the applicable installment obligations of all of the group members without regard to the actual outstanding indebtedness of the particular members. The proportionate disallowance rule is then applied to accelerate an appropriate amount of the gain that would have otherwise been deferred with respect to the applicable installment obligations.[22] The effective date for these rules may be after the effective date of the TRA 1986 amendments but prior to the eventual issuance date of the regulations.[23]

Similarly, the Act grants the Treasury the authority to promulgate regulations disallowing the use of the installment method in whole or in part for transactions in which the effect of the proportionate disallowance rule would be avoided through the use of related parties, pass-through entities, and intermediaries.[24] The Conference Report indicates, for example, that the regulations should, in appropriate cases, aggregate the assets and liabilities of a partnership and its partners in determining the extent to which partners may report gain from the sale of partnership assets under the installment method. Moreover, in a case where a taxpayer sells his interest in a related party (*i.e.*, a partner sells his partnership interest), any installment obligations arising from the sale will be treated as applicable installment obligations to the extent that a sale of the underlying assets of the related party would give rise to applicable installment obligations.[25]

d. Alternative Minimum Tax

As enacted by §701 of TRA 1986, new §56(a)(6) provides that the installment method of accounting does not apply for purposes of the revised alternative minimum tax (for both individuals and corporations) as to (i) post-March 1, 1986, dealer dispositions and (ii) other dispositions subject to the proportionate disallowance rules (post-August 16, 1986 sales). Thus, for purposes of the revised alternative minimum tax, all gain realized on a disposition of the type described above is treated as reported in the year of disposition. In ensuing years when the deferred installment gain is reported for regular tax purposes, that gain is completely eliminated from alternative minimum taxable income.

The new alternative minimum tax provisions are analyzed in Chapters 32 and 33.

e. Timeshares and Residential Lots

Section 453C(e)(4) creates special exceptions to the disproportionate disallowance rule for certain sales of timeshare interests and unimproved residential lots. Dealers selling timeshares or unimproved lots in the ordinary course of their trade or business may elect to preclude the proportionate disallowance rule from applying to installment obligations arising from such sales. In the case of sales of lots, the election is available only where the land is sold in an unimproved condition and neither the seller nor an affiliate will subsequently develop it.[26] For these purposes, however, the installation of roads and sewers will not be treated as development or improvement activity.[27] In order for this election to be available with respect to sales of either lots or timeshare interests, the sale must be to an individual and the individual's installment obligation may not be guaranteed or insured by any third person other than an individual.[28] Thus, the existence of insurance covering the individual's obligation to pay the debt will preclude the obligation from qualifying for the election regardless of whether the insurance is provided by the Federal government or a private concern.[29]

Section 453C(e)(4)(A)(i)(I) defines a timeshare as the right to use a specified parcel of residential real estate for a period not exceeding six weeks per year.[30] Finally, in applying the six-week limitation described above, timeshare rights of certain relatives (spouse, child, grandchild, parent) are treated as being owned by the individual who finances his purchase with an installment obligation.[31]

If a taxpayer elects the special rule applicable to timeshares and unimproved residential lots, upon receiving payments due under the installment obligations, the taxpayer must pay interest to the Federal government, at a rate equal to the applicable Federal rate under §1274, on the tax deferred under the installment method. Such interest compounds semiannually and is payable over the life of an installment obligation as payments are received. Thus, upon receipt of a payment, the taxpayer must pay the interest accruing on the deferred tax liability attributable to that particular payment.[32]

f. Exception for Certain Sales by Manufacturers to Dealers

TRA 1986 provided one other exception from the proportionate disallowance rule for installment obligations arising from the sale of tangible personal property by a manufacturer (or one of its affiliates) to a dealer, provided that (i) the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, and (ii) the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price following no more than nine months after the sale to the dealer.[33] Further, in order for the exception to apply, the aggregate face amount of the installment obligations from the sale of tangible personal property by the manufacturer to dealers (which meet the requirements described previously) must equal at least 50% of the total sales to dealers that give rise

[22] Conference Report at II-298.
[23] Conference Report at II-299.
[24] §453C(e)(5)(A); Conference Report at II-298-99.
[25] Conference Report, at II-299.
[26] §453C(e)(4)((A)(i)(II); Conference Report at II-296.
[27] Senate Report, at 129, footnote 12.
[28] §453C(e)(4)((A)(ii).
[29] Senate Report, at 129, footnote 11.
[30] An installment obligation resulting from the sale of a right to use specified campgrounds for recreational purposes over an ascertainable period of time also qualifies for the election under §453C(e)(4). *See* Senate Report at 129-30.
[31] §453C(e)(4)(A); Conference Report at II-299.
[32] §453C(e)(4)(B).
[33] Act §811(c)(2)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

to such receivables in both the current taxable year and the preceding taxable year (the "50% test").[34] The taxpayer will be treated as failing to meet the 50% test only if the taxpayer fails to meet the test for both the taxable year and the preceding taxable year.[35] The determination of the amount of the taxpayer's receivables is made using a weighted average on a monthly basis.[36] Obligations issued prior to the enactment of TRA will be considered to meet the requirements of the exception if the obligations are conformed to the requirements of the Act within 60 days of enactment.[37]

Obligations that qualify under the exception described above are not treated as applicable installment obligations.[38]

2. Revolving Credit Plans

TRA 1986 added §453(j) precluding the use of the installment method by taxpayers who sell property on a revolving credit plan. For these purposes, the Act incorporates the definition of "revolving credit plan" from Regs. §1.453-2(d).[39] All payments to be received with respect to sales under a revolving credit plan will be treated as received in the year of disposition. Thus, the effect of the repeal is to mandate the use of the accrual method of accounting for these sales.

3. Publicly-Traded Property

New §453(j) also denies the use of the installment method for sales of stock or securities that are traded on an established securities market and, to the extent provided in regulations, other property of a kind regularly traded on an established market. The Act effectively requires taxpayers to account for sales of these types of property under the accrual method, and all payments will be treated as received in the year of disposition.

The legislative history indicates that Congress determined that, as a matter of tax policy, sales of publicly-traded property should not be eligible for the installment method since the liquid nature of the property ensures that a taxpayer can always easily sell the property on the public market.[40] The committee reports, however, provide no guidance as to what types of property, other than stock or securities, should be ineligible for the installment method under the eventual regulations.

Comment: Under the pre-1986 TRA installment method rules, a seller's debt instruments that are "readily traded in an established securities market" are treated as a payment in the year of sale.[41] Presumably, the regulations implementing the TRA rules applicable to publicly-traded property will incorporate guidelines similar to those in Temp. Regs. §15A.453-1(e)(4) in defining the terms "readily traded" and "established market." According to the legislative history, where sales take place on an established market and cash settlement generally occurs several days after the trade date, both cash and accrual basis taxpayers will recognize gain or loss on the day the trade is executed and not on the day when settlement occurs.[42]

Congress also directed the Treasury to issue regulations preventing the avoidance of the above rules through the use of related parties or other intermediaries. For example, if a taxpayer sells his stock in a wholly owned corporation, the only assets of which are stock or securities that are traded on an established securities market, the taxpayer will not be able to use the installment method for reporting gain on the sale of stock. This rule, however, will not apply where the person selling the interest could not have caused the entity to sell its publicly-traded stocks or securities (*i.e.*, the seller is a non-controlling partner in a large partnership).[43]

4. Effective Dates

a. Disproportionate Disallowance Rule

The proportionate disallowance rule generally applies to taxable years ending after December 31, 1986, with respect to dispositions made after February 28, 1986.[44] A taxpayer must treat installment obligations arising from sales after February 28, 1986 but before the first taxable year ending after December 31, 1986 as having arisen during the first taxable year of the taxpayer beginning after December 31, 1986.[45] This rule generally will apply to calendar year taxpayers who hold installment obligations arising from 1986 sales that closed after February 28, 1986.

With respect to installment obligations arising from the sale of real property in the ordinary course of a trade or business, any gain from AII allocated to installment obligations that arise (or are deemed to arise) in the first taxable year ending after December 31, 1986 is taken into account ratably over the three taxable years beginning with such taxable year. For any installment obligation arising in the second taxable year of the taxpayer ending after December 31, 1986, the gain is taken into account ratably over the two taxable years beginning with that year. Notwithstanding, the rules relating to subsequent payments on applicable installment obligations shall apply to cases covered by this transition rule as though the proportionate disallowance rule was fully effective in the first taxable year ending after December 31, 1986.[46]

If an installment obligation arises from the sale of personal property in the ordinary course of a trade or business of the taxpayer, any increase in the taxpayer's tax liability for the first taxable year ending after December 31, 1986 on account of the proportionate disallowance rule is treated as being imposed ratably over the three taxable years beginning with such taxable year. Any increase in tax liability for the second taxable year of the taxpayer ending after December 31, 1986 on account of the proportionate

[34] Act §811(c)(2)(B)(i).
[35] Act §811(c)(2)(B)(ii).
[36] Senate Report at 130.
[37] *Id.*, Act §811(c)(2)(C).
[38] Act §811(c)(2)(D); Senate Report at 130.
[39] Conference Report at II-297. The regulation is described, *supra*, at I, A, 1.
[40] Senate Report at 124.
[41] *See* pre-1986 TRA §453(f)(4), (5).
[42] Senate Report at 131.
[43] Senate Report at 131.
[44] Act §811(c)(1).
[45] Conference Report at II-300.
[46] Act §811(c)(6); Conference Report at II-300.

disallowance rule (disregarding the ratable share of increase from the preceding taxable year) is treated as being imposed ratably over the two taxable years beginning with such taxable year. As in the case of the transition rule for dealer real estate, the rules relating to subsequent payments on applicable installment obligations apply as though the proportionate disallowance rule was fully effective for taxable years ending after December 31, 1986.[47]

For applicable installment obligations other than those arising from the sale of real or personal property in the ordinary course of the taxpayer's trade or business, the proportionate disallowance rule is effective for taxable years ending after December 31, 1986, *with respect to sales after August 16, 1986*. Sales after August 16, 1986 but before a taxpayer's first taxable year ending after December 31, 1986 are to be treated as arising in the first taxable year of the taxpayer ending after December 31, 1986. Conference Report at II-300.

b. Revolving Credit Plans

The elimination of the installment method for sales on revolving credit plans is effective for taxable years beginning after December 31, 1986.[48] Taxpayers who use the installment method for sales of property under revolving credit plans and must change their method of accounting may include the adjustment to income from ceasing to use the installment method over a period not exceeding four years. The percentage of the adjustment will be included in those four years beginning with the first taxable year beginning after December 31, 1986 as follows:[49]

Year 1	15%
Year 2	25%
Year 3	30%
Year 4	30%

c. Publicly-Traded Property

The repeal of the installment method for sales of publicly-traded property applies to taxable years beginning after December 31, 1986.[50]

II. The Impact of the General Utilities Repeal on Installment Sales Rules

A. Introduction

Before the enactment of TRA 1986, a corporation liquidating under §337 could distribute certain installment obligations to its shareholders without accelerating the gain deferred with respect to the obligations under the installment method. That is, under pre-1986 TRA §453(B)(d)(2), the distribution in liquidation would not be treated as a disposition of the installment obligations accelerating the remaining gain. Identical treatment was available under pre-1986 TRA §453(B)(d)(1) for distributions of installment obligations in connection with §332 liquidations.

In order to qualify for the special treatment described above in a §337 liquidation, the installment obligations distributed to the shareholders must have arisen from sales of the distributing corporation's assets occurring after the adoption of the plan of liquidation. Furthermore, if the obligations arose from the sale of the corporation's inventory, the sale was required to qualify as a bulk sale as defined in §337(b)(2) (as well as satisfy the requirement that it occur on or after the date of adoption of the plan). If these requirements were satisfied, the distribution of the installment obligations by the liquidating corporation would not constitute a disposition for purposes of §453, provided that the distribution occurred within the twelve-month liquidation period called for by §337. However, the liquidating corporation would recognize ordinary income to the extent that the various recapture provisions (*e.g.*, §§1245 and 1250) apply.[51]

Following the enactment of the Installment Sales Revision Act of 1980, it also became possible for shareholders who received a distribution of installment obligations satisfying the above rules effectively to "assume" the corporation's installment method treatment with respect to the obligations. That is, the shareholders were entitled to treat the receipt of the deferred payments under the obligations as a payment (when received) in respect of their stock (rather than being required to treat the receipt of the *installment obligations* as a payment in exchange for stock).[52]

As described in Chapter 36, Congress determined that virtually all distributions by liquidating corporations should trigger corporate-level tax. This so-called repeal of the *General Utilities* doctrine generally repealed §337. Chapter 36 also discusses the transition rules applicable to certain small, closely-held corporations. These corporations will continue to be eligible for the pre-TRA 1986 provisions of both §337 and the installment sales rules.

B. Detailed Analysis

Certain conforming amendments enacted by §631(e) of TRA 1986 amended the installment sales rules so as to implement the repeal of the *General Utilities* doctrine. Specifically, Act §631(e)(9) repeals the exception previously provided for distributions pursuant to §337 liquidations.[53] Thus, except in those cases covered by special transition rules, a liquidating distribution by a corporation of installment obligations arising from sales of its property (regardless of whether such sales occur before or after the adoption of the plan of liquidation) will constitute a disposition of the obligations and accelerate all gain that had theretofore been deferred under the installment method rules. Thus, the gain will be recognized by the liquidating corporation in the year of the distribution.

Because TRA 1986 continues to allow a parent to liquidate an 80% controlled subsidiary without triggering gain at the subsidiary level, §453B(2) continues to provide an exception from the disposition rules for installment obligations distributed pursuant to a §332 liquidation.

[47] Act §811(c)(7); Conference Report at II-300.
[48] Act §812(c)(1).
[49] Act §812(c)(2); Conference Report at II-301.
[50] Act §812(c)(1).
[51] Pre-1986 TRA §453B(d)(2); Regs §1.453-9(c)(1)(ii).
[52] Pre-1986 TRA §453(h)(1)(A).
[53] Pre-1986 TRA §453B(d)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Thus, where an installment obligation is distributed in a §332 liquidation and the basis of such obligation in the hands of the parent corporation is determined under §334(b)(1), the subsidiary will not recognize gain on the distribution of the installment obligation.[54]

Notwithstanding the above amendments, shareholders receiving certain installment obligations in a §331 liquidation can continue to "assume" the installment method for purposes of reporting their gain on the distribution. Consequently, the shareholders receiving the installment obligations will treat subsequent payments under the obligations as payments in exchange for their shares.[55] To qualify for this provision, the distributed installment obligations must arise out of a sale or exchange by the distributing corporation of its assets during the 12-month period beginning on the date the plan of complete liquidation was adopted. Further, the liquidation must be completed within the 12-month period. If these conditions are satisfied, the distribution of the installment obligations generally will not constitute a payment to the distributee shareholder in exchange for his stock.

TRA 1986, however, carries over certain other restrictions from prior law. First, the deferral treatment available under §453(h) to shareholders who receive distributions of installment obligations is not available with respect to installment obligations arising from the sale of the distributing corporation's inventory other than inventory sold in a bulk sale.[56] As under prior law, §453(h)(1) defines a bulk sale as a sale of substantially all of the corporation's inventory to a single person. Further, as under pre-1986 TRA law, shareholder distributees cannot take advantage of §453(h)(1) where the obligor under the distributed installment obligation is related to the shareholder within the meaning of §1239(b) and the corporate property sold consists of depreciable property.[57]

The conforming amendments to the installment sales rules enacted by §631(e) of TRA 1986 incorporate the same effective dates and transitional rules as the broader amendments contained in §631. These rules, set forth in Act §633, are described in detail in Chapter 36.

[54] §453B(d).
[55] §453(h)(1).
[56] §453(h)(1)(B).
[57] §453(h)(1)(C).

III. Recognition of Section 751 Gain in an Installment Sale

Section 112 of the Tax Reform Act of 1984 amended §453(i) to provide that "recapture income" arising from an installment sale will be recognized in the year of disposition regardless of the amount of payments received by the seller in that year. Under the 1984 amendment, the seller's gain in excess of the recapture income continued to be recognized in accordance with the standard rules governing installment sales. The 1984 Act defined "recapture income" as the amount which would be treated as ordinary income under §1245 or §1250 in the year of the disposition if all payments payable pursuant to the terms of the sale were received in that first year.[58]

Comment: Before the 1984 Act, all gain recognized under the installment sales method was treated as ordinary income until the full amount of recapture income was reported by the seller. The ordinary income, however, was reportable in accordance with the installment method (*i.e.*, as payments were received by the seller). Thus, the 1984 Act mandated an acceleration of all recapture income in the year of disposition of the property regardless of whether the seller received payments in that year that would otherwise give rise to gain under the installment method.

The Technical Corrections included in Title XVIII of TRA 1986 amended §112 of the 1984 Act. Specifically, Act §1809(c) amended §453(i) to clarify that the depreciation recapture rules apply to an installment sale of a partnership interest. That is, TRA 1986 amended the definition of "recapture income" in §453(i)(2) to provide that the term includes not only the amount of ordinary income that would be recaptured under §1245 or §1250 upon a sale, but also the amount of ordinary income that would be recaptured under §751 by reason of §751 treating §1245 and §1250 recapture as an "unrealized receivable." The effect of the technical correction is to ensure that the recapture provisions of §453(i) cannot be avoided by selling a partnership interest in an entity that owns property subject to recapture.

The technical correction included in §1809(c) of TRA 1986 is effective as though it were included in section 112 of the 1984 Act.[59] Consequently, §453(i), as amended, generally applies to dispositions made after June 6, 1984, unless the disposition was made pursuant to a contract that was binding on March 22, 1984 and at all times thereafter.[60]

[58] §453(i)(2).
[59] Act §1881.
[60] Tax Reform Act of 1984, §§112(b)(1), (b)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 19

NEW CAPITALIZATION RULES FOR DEALERS AND PRODUCERS

Charles E. Taylor, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

The Act [1] adds new §263A to the Code [2] which changes the accounting treatment of costs for property produced by the taxpayer (inventory of manufacturers, self-constructed assets, and noninventory property produced for sale) and property held by a taxpayer for resale (inventory of retailers and wholesalers).

A. Pre-TRA 86 Law

Generally taxpayers which produce, purchase or sell property in the ordinary course of their business must accumulate the cost of that property in inventory and deduct it when the property is sold.[3] The purpose of maintaining inventories is to assure that the costs of producing or acquiring goods are matched with the revenues realized from their sale. This is accomplished by accumulating these costs when they are incurred and disallowing a current deduction until sold or only as consumed.

There are generally three types of taxpayers which have inventories — manufacturers, wholesalers, and retailers.

1. Purchasers of Goods for Resale

Wholesalers and retailers generally purchase the goods which they include in their inventories and include only direct acquisition costs in inventory. The inventory cost for retailers and wholesalers should include the invoice price of goods less trade or other discounts plus transportation and other necessary charges incurred in acquiring possession of the goods.[4] Cash discounts, approximating a fair interest rate, may or may not be deducted at the taxpayer's option, providing it follows a consistent practice. Costs in acquiring possession of goods may include brokerage or franchise service fees and handling charges.[5] Storage costs are generally not added to the costs of goods but are currently deducted by the taxpayer.[6]

2. Goods Manufactured for Inventory

Manufacturers may produce goods for their inventory, for sale to customers on special order, or for their own use. If a manufacturer produces goods for inventory, it must inventory all costs in accordance with the "full absorption" method prescribed in Regs. §1.471-11. These regulations require that all direct costs — materials forming an integral part of the product or consumed in the manufacturing process and labor directly involved in the fabrication of the product — be included in the cost of items in inventory. Direct labor costs include not only wages and salaries of production workers and supervisors, but also such items as vacation and holiday pay, payroll taxes, and payments to supplemental unemployment benefit plans paid or incurred on behalf of employees engaged in direct labor.[7]

Indirect costs are divided into three categories — those which must be included in inventory, those which the taxpayer can choose to include in inventory or currently deduct, and those which the taxpayer must include in inventory if it has included the costs in inventory for financial statement purposes. Costs which a taxpayer is required to inventory are repair expenses, maintenance, utilities (such as heat, power, and light), rent, indirect labor and production supervisory wages (including basic compensation, overtime pay, vacation and holiday pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plans), indirect materials and supplies, tools and equipment not capitalized, and costs of quality control and inspection to the extent such costs are incident to and necessary for production or manufacturing operations or processes.[8]

Costs which a taxpayer may currently deduct include marketing, advertising, selling, and other distribution expenses; research and experimental expenses, (including engineering and product development expenses); losses under §165; percentage depletion in excess of cost depletion; depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported for financial statement purposes; income taxes attributable to income received on the sale of inventory; pension contributions to the extent they represent past service costs; general and administrative expenses incident to and necessary for the taxpayer's activities as a whole, rather than to production or manufacturing operations or processes; and salaries paid to officers attributable to the performance of services that are incident to and necessary for the taxpayer's activities as a whole, rather than to production or manufacturing operations.[9]

Costs for which capitalization depends on financial statement treatment include taxes otherwise allowable as a deduction under §164 (other than state, local, and foreign income taxes) attributable to assets incident to and neces-

---

[1] Tax Reform Act of 1986, P.L. 99-514 (October 22, 1986).
[2] All section references in this Chapter are to the Internal Revenue Code of 1986, and the regulations thereunder, unless otherwise indicated.
[3] Regs. §1.471-1.
[4] Regs. §1.471-3(b).
[5] *See* Rev. Rul. 80-141, 1980-1 C.B. 111; *McDonald v. Comr.*, 2 B.T.A. 906 (1925).
[6] *McIntosh-Mills v. Comr.*, 9 B.T.A. 301 (1927), acq. VII-1 C.B. 21.
[7] Regs. §1.471-11(b)(2).
[8] Regs. §1.471-11(c)(2)(i).
[9] Regs. §1.471-11(c)(2)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

sary for production or manufacturing operations; depreciation reported on financial statements and cost depletion on assets incident to and necessary for production; pension and profit-sharing contributions representing current service costs otherwise allowable as a deduction under §404, and other employee benefits incurred on behalf of labor incident to and necessary for production; costs attributable to rework labor, scrap, spoilage, and strikes that are incident to and necessary for production; factory administrative expenses (not including any cost of selling or any return of capital); salaries paid to officers attributable to services performed incident to and necessary for production; and insurance costs incident to and necessary for production; (*e.g.*, insurance on production machinery and equipment).[10]

If a taxpayer uses a method of accounting for financial reporting purposes that would not be allowable for federal income tax purposes (such as the "prime cost" method, which includes as inventory costs only direct costs), taxes otherwise allowable as a deduction under §164 (other than state, local and foreign income taxes), depreciation and amortization reported for financial statement purposes, production-related administrative costs, production-related officers' salaries, and production-related insurance costs must be taken into account in inventory. However, in these circumstances, employee benefit costs and costs attributable to strikes, rework labor, scrap, and spoilage need not be included in inventory costs.[11]

Indirect production costs required to be treated as inventory costs must be allocated to goods in a taxpayer's ending inventory using a method of allocation that fairly apportions such costs among the goods produced. The regulations authorize use of the standard cost method, the practical capacity method or the manufacturing burden rate method.[12] In general, the standard cost method assigns a predetermined rate (*e.g.*, $X per direct labor hour) for each element of product cost, including direct materials and labor and fixed and variable overhead. The manufacturing burden rate method is similar to the standard cost method but assigns predetermined rates only to overhead costs. The practical capacity method, which is one form of standard costing, determines the amount of fixed indirect production costs which must be allocated to inventory based on actual production and allows the deduction of those fixed indirect productions costs attributable to unused capacity.

3. Self-constructed Property and Non-inventory Goods Manufactured for Sale

If a manufacturer produces for itself goods that have a useful life which extends beyond the end of the taxable year, it is required to capitalize the direct materials and labor costs associated with that project.[13] Such "capital" expenditures become part of the basis of the acquired, constructed, or improved property. These costs may be recovered over the useful life of the property through depreciation or amortization deductions if the property is used in a business or investment activity and has a determinate useful life, and is therefore subject to an allowance for depreciation or amortization. Otherwise, such costs are recovered when the property is sold or otherwise disposed of. At the time of sale or other disposition, any unrecovered basis of the asset is offset against the amount realized in computing gain or loss.

Depreciation on property used in the construction for a project must also be capitalized.[14] The treatment of other indirect costs as capitalized costs or currently deductible expenses, however, is not clear. Some cases require that indirect costs attributable to a project be capitalized[15] while other cases only require the capitalization of incremental or variable indirect costs.[16] Under Treasury regulations, the use of "incremental" costing for indirect costs (in lieu of full absorption costing) is expressly proscribed in the case of inventories of manufacturers, but no such prohibition applies for self-constructed property. In some instances, the IRS has acknowledged the deductibility of certain indirect costs incurred during self-construction. In *Idaho Power*, for example, the Service conceded that the taxpayer was entitled to deduct payroll taxes incurred with respect to employees engaged in construction of the property.

4. Construction Period Interest and Taxes

Interest and taxes incurred during construction or improvement of real property (other than low income housing) to be used or held for sale in a trade or business must be capitalized and recovered upon the sale of the property or through amortization over a ten year period.[17] The construction period begins when the construction of the building or other improvements commences and ends on the date it is ready to be placed in service or held for sale. The amount of interest which must be capitalized is that portion of the total interest incurred during the construction period which could have been avoided if funds had not been expended for construction.[18]

5. Sales Taxes

Real and personal property taxes, sales taxes, and other state, local and foreign taxes paid or accrued in a taxable year in the carrying on of a business or investment activity are deductible for federal income tax purposes.[19] The restrictions in §189, discussed previously, and §263 (capital expenditures for buildings, or improvements or betterments made to increase the value of property) may limit those deductions.

B. Reasons for Change

Both Congressional tax-writing committees believed that the current rules regarding the capitalization of costs incurred in producing property were deficient. The existing

[10] Regs. §1.471-11(c)(2)(iii).
[11] Regs. §1.471-11(c)(3).
[12] Regs. §1.471-11(d).
[13] §263.

[14] *Idaho Power Co. v. Comr.*, 418 U.S. 1 (1974).
[15] *See Adolph Coors Co. v. Comr.*, 519 F.2d 1280 (10th Cir. 1975); *Louisville & Nashville R.R. Co. v. Comr.*, 641 F.2d 735 (6th Cir. 1981) aff'g, rev'g and rem'g in part 66 T.C. 962 (1976); and *Variety Construction Co. v. Comr.*, T.C. Memo 1962-257.
[16] *Fort Howard Paper Co. v. Comr.*, 49 T.C. 275 (1967) (allowing incremental method because of taxpayers long standing use of method and prior IRS acquiescence); *Paducah Water Co. v. Comr.*, 33 F.2d 559 (D.C. Cir. 1929).
[17] §189 of 1954 Code.
[18] *See* H. Rep. No. 97-760, 97th Cong. 2d Sess. 485 (1982); Financial Accounting Standards Board, Capitalization of Interest Cost, Statement No. 34 (October, 1979).
[19] §164(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

rules might allow costs that were in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized as part of the basis of the property and recovered when the property was sold or as it was used by the taxpayer. This produced a mismatching of expenses and the related income and, in the opinion of the committees, an unwarranted deferral of taxes. Also, different capitalization rules might apply under current law depending on the nature of the property and its intended use. These differences might create distortions in the allocation of economic resources and the manner in which certain economic activity was organized.[20]

The committees further believed that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome. The Senate Finance Committee believed that the treatment of taxes upon the sale or purchase of a capital asset used in a business or investment activity should be consistent with the treatment of other costs incurred in the disposition or acquisition of such assets.[21]

II. Overview

A. General Rule

The 1986 TRA directs the Treasury Department to prescribe a uniform set of capitalization rules applicable to all costs incurred in manufacturing or constructing property, and in purchasing and holding property for resale. These rules should be similar to those currently applied to extended period long-term contracts. Interest costs will be subject to capitalization if they are allocable to the construction of real property, or personal property that is long-lived property or requires an extended period to produce.

B. Expenses Other Than Interest

The Treasury Department is directed to prescribe regulations that will govern the inclusion in inventory or capital accounts of all costs, both direct and indirect (including taxes), which are (1) involved in the manufacture, construction, and other types of activity involving the production of real or tangible personal property, and (2) for large taxpayers, involved in the acquiring or holding for resale of inventory or other property acquired or held in the ordinary course of a trade or business. These rules will be similar to those currently applied to extended period long-term contracts. The rules do not modify existing treatment of the valuation of inventories on a basis other than cost (*e.g.*, lower of cost or market valuations for first-in, first-out (FIFO) inventories).

Property produced in a farming business (as defined in §2032A and which is not required to use the accrual method of accounting under §§447 or 448(a)(3)) where the preproductive period is less than two years is not subject to the uniform capitalization rules. There is also a special election out of the uniform capitalization rules for most farmers. The price which the electing farmer must pay is that its plants and animals will be treated as §1245 property and gain upon the sale of the plant or animal will be taxed as ordinary income to the extent of the deductions taken as a result of the election. The farmer (and related parties) must also depreciate all property predominately used in the farming business and placed in service in any taxable year in which the election is in effect, based on the new alternative depreciation method in §168(g).

The new rules prescribe in some detail the costs which taxpayers who acquire property for resale (generally retailers and wholesalers) must allocate to inventory. Retailers and wholesalers will not be subject to the more stringent capitalization rules if their average annual gross receipts for the three preceding taxable years are $10,000,000 or less. The Treasury Department should prescribe elective rules for simplified uniform capitalization rules for retailers and wholesalers and include extensive examples on which taxpayers may rely prior to the issuance of regulations.

There will be no allocation of general and administrative costs resulting from research and experimental expenditures under §174 or of development and other costs of oil and gas wells or mineral property which qualify under §§263(c) and 616(a).

C. Interest Capitalization

Interest on debt is not treated as a cost allocable to inventory or items produced by the taxpayer. However, interest paid or incurred during the production period must be capitalized (1) for indebtedness directly attributable to production expenditures with respect to real or tangible personal property produced by a taxpayer, or (2) for indebtedness that could have been reduced if production expenditures had not been incurred. Also, interest on indebtedness incurred or continued in connection with property used to produce property to which new §263A(f) applies will also be subject to this limitation. Those production expenditures which are covered by this section include expenditures for property which (1) has an estimated production period exceeding two years, (2) has an estimated production period exceeding one year if its cost exceeds $1,000,000, or (3) is real property, or personal property with a class life of 20 years or more (*i.e.*, 15- and 20-year property). The production period begins when construction or production commences and ends when the property is ready to be placed in service or is ready to be held for sale. The determination of whether interest is incurred or continued for the production of property should be similar to the rules under current §189, which is repealed.

D. Sales and Transfer Tax Capitalization

As part of the repeal of the current deduction for state and local sales taxes, the 1986 TRA provides that any tax (other than certain property and income taxes) imposed upon the acquisition or disposition of property shall be treated as part of the acquisition cost or a reduction in the proceeds received upon the property's disposition.

E. Effective Date

In general the uniform capitalization rules are effective for costs and interest paid or incurred after December 31,

[20] House Committee on Ways and Means, Tax Reform Act of 1985, H.R. Rep. 99-426, 99th Cong., 1st Sess. at 625 (Dec. 7, 1985) (hereinafter referred to as the "House Report"); Senate Committee on Finance, Tax Reform Act of 1986, S. Rep. 99-313, 99th Cong., 2nd Sess. at 140 (May 29, 1986) (hereinafter referred to as the "Senate Report").

[21] Senate Report at 57.

1986. However, there is an exception for self-constructed assets with respect to which substantial construction had occurred prior to March 1, 1986. Such assets will remain subject to the current tax accounting rules.

Taxpayers who use inventories are required to restate their inventory balances as of the beginning of the first taxable year beginning after December 31, 1986. In effect, beginning inventory must be revalued to reflect the greater deferral of production costs under the new rules. The increase in the inventory value resulting from this change, *i.e.*, the §481 adjustment, will be spread over the period which the taxpayer has used inventories or four years, whichever is less. The timing for inclusion of the §481 adjustment in income will be governed by Rev. Proc. 84-74. Any positive §481 adjustment will be allowed to offset net operating loss and tax credit carryforwards, and that for purposes of determining estimated tax payments, the adjustment will be recognized ratably throughout the year.

III. Detailed Analysis

The Act prescribes a uniform set of capitalization rules applicable to all costs incurred in manufacturing or constructing property, and in purchasing and holding property for resale. In addition, interest costs will be subject to capitalization if they are allocable to the construction of real property or personal property that is long-lived property to be used by the taxpayer or requires an extended period to produce.

A. Uniform Capitalization Rules

1. Basic Changes

The Treasury Department is directed to prescribe regulations that will govern the inclusion in inventory or capital accounts of all costs, both direct and indirect (including taxes), involved in manufacturing, construction, and other types of activity of real or personal property and, for certain large taxpayers, are involved in the acquiring or holding for resale of inventory or other property in the ordinary course of a trade or business.[22] The rules will apply to all real and tangible assets and those intangible assets which are acquired for resale.[23] Intangible assets which are produced by a taxpayer are not subject to the uniform capitalization rules. The rules do not modify existing treatment of the valuation of inventories on a basis other than cost (*e.g.*, valuation of inventories at market by a taxpayer using the lower of cost or market method, or valuation of security inventories at market).[24] However, the Conference Report states that the rules will apply to inventories valued at cost by a taxpayer using the lower of cost or market method. Property produced by a taxpayer for use other than in a trade or business or activity engaged in for profit also will be exempt from these rules.[25]

The new capitalization rules are not intended to modify present law governing the determination of whether an expenditure results in a separate and distinct asset that has a useful life substantially beyond the taxable year.[26] The rules merely prescribe those costs associated with a capital asset that must be included in its basis or otherwise capitalized. The standard which the Treasury is to use in determining which indirect costs should be capitalized are those rules applicable to extended period long-term contracts, set forth in Regs. §1.451-3.[27] The rules are also not intended to change the deductibility of costs that are properly treated as repair costs under current law and that do not relate to the manufacture, remanufacture, or production of property.[28] Also, "cushion gas," the gas necessary to maintain operating pressure in an underground gas storage facility sufficient to meet peak customer demand, as well as some portion of the "emergency reserve" gas, will not be allocated to overhead or other indirect costs under the uniform capitalization rules.[29]

Contributions to a qualified pension, profit-sharing, or stock bonus plan and other employee benefit expenses are considered indirect costs which must be capitalized as any other indirect cost unless the contribution relates to past service costs.[30] The determination of whether a contribution to a qualified plan relates to past services does not depend on the allocation between "normal cost" and "past service costs" required under the minimum funding standard of §412 or the plan's benefit formula. The determination may be based in part on any actuarial funding methods that may be used by qualified defined benefit plans.[31] The allocation of costs of qualified plans will be made after determination of any applicable limitations on deductions for federal income tax purposes. In other words, a taxpayer may not allocate employee benefit costs which are not otherwise currently deductible (for example, because of the limits in §404) to inventory or to a capital account while deducting the full amount of deductible employee benefit expenses as a current expense.[32]

The regulations are expected to be patterned after the rules currently applicable to extended period long-term contracts.[33] Thus, manufacturers which were not subject to the extended period long-term contract rules must now capitalize warehousing of finished goods, depreciation or

[22] §263A(a), (b), and (h).

[23] *Id.* Under §263A(b), tangible property includes films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, these rules will apply to the production of a motion picture or writing of a book and will supercede the provisions of repealed §280 of the 1954 Code. Act §803(b)(2)(A). No inference is intended as to the nature of these properties under present law or for other provisions of the Act. Committee of Conference, Tax Reform Act of 1986, Conference Report to Accompany H.R. 3838, H. Rep. 99-841, 99th Cong. 2d Sess. II-308 (hereinafter referred to as the "Conference Report").

[24] Conference Report at II-305.

[25] §263A(c)(1).

[26] Senate Report at 141. For example, goodwill which is deductible under pre-1986 TRA law will remain currently deductible under the Act. *See* Regs. §1.263(a)-1, (a)-2; and *Comr. v. Lincoln Savings and Loan*, 403 U.S. 345 (1971).

[27] Senate Report at 141.

[28] Senate Report at 143.

[29] Conference Report at II-305.

[30] Senate Report at 142; *see* Regs. §1.451-3(d)(6)(iii)(I).

[31] Senate Report at 142-3.

[32] *See* Senate Report at 143.

[33] Senate Report at 141. The House Report stated that the rules would be patterned after rules in current law applicable to extended period long-term contracts as well as the full absorption rules. House Report at 626 (note 42). The Conference Report indicates that it basically follows the Senate Amendment to H.R. 3838, and so it appears that more reliance should be placed on the extended period long-term contract rules than on the full absorption regulations in determining possible provisions prior to issuance of temporary regulations.

depletion for tax purposes (not just financial accounting purposes), rework, scrap, spoilage, current service costs of pension and profit sharing plans, and direct and indirect service support functions.

Comment: Taxpayers might consider requesting the permission of the IRS to change to an inventory method which allows more current deduction of costs. Such a method might be the practical capacity method which allows a deduction for that portion of fixed indirect costs which are attributed to unused capacity.

Since the extended-period long-term contract regulations deal primarily with production involving contracts, the Treasury Department is given the flexibility to adapt the rules to production which does not involve contracts.[34] Thus, taxpayers will be required to defer deduction of indirect costs that benefit assets produced or acquired for resale. The regulations are to provide the same flexibility for allocations which is allowed for indirect costs allocable to extended period long-term contracts.[35]

For example, retailers and wholesalers should now be required to inventory costs incident to purchasing inventory (*e.g.*, wages or salaries of employees responsible for purchasing), costs for repackaging and assembling goods, costs of processing goods while in the taxpayer's possession, costs of storing goods (including rent or depreciation, insurance and taxes attributable to a warehouse and wages of warehouse personnel),[36] and general and administrative costs allocable to these functions. For retailers, only offsite storage costs (*i.e.*, a facility distinct from the facility wherein the taxpayer conducts his business) will be included in inventory; the cost of the facility where the retailer conducts its retail sales will continue to be currently deductible.[37]

There will be no allocation of general and administrative costs resulting from research and experimental expenditures under §174 or the development and other costs of oil and gas wells or mineral property which qualify under §§263(c), 616(a), or 617(a).[38] As in the long-term contract rules, selling, marketing, advertising and distribution expenses are not subject to the uniform capitalization rules.[39] The new capitalization rules under §263A do not apply, however, to contracts to which the long-term contract rules apply.[40] Unlike the Senate bill, the Act provides that depreciation for assets purchased prior to the effective date will be capitalized or added to inventory for the tax years in which the Act is effective.[41]

2. Exception for Certain Farm Property

a. General Rule

Property produced in a farming business (as defined in §2032A and which is not used by a taxpayer required to use the accrual method of accounting under §§447 or 448(a)(3)) where the preproductive period is less than two years is not subject to the new capitalization rules.[42] A farming business is the trade or business of farming and includes the operation of a nursery or sod farm, and the raising or harvesting of trees bearing fruit, nuts or other crops or ornamental trees (but excluding evergreen trees which are more than six years old at the time they are severed from their roots).[43] If plants bearing an edible crop for human consumption are lost or damaged (while in the hands of the taxpayer) from freezing temperatures, disease, drought, pests, or casualty, the capitalization rules do not apply to the costs of replanting the plants bearing the same type of crop on the same parcel of land or another parcel (for the same amount of acreage) in the United States.[44] It appears that this exception is available to farmers who are required to use the accrual method of accounting.

Even if the capitalization rules apply to farming property, the House Committee Report indicates that farmers and ranchers may determine the costs required to be capitalized by using a method similar to one of the simplified inventory valuation methods of current law (*e.g.*, the farm price or unit-livestock-price method), in lieu of capitalizing actual costs.[45]

Comment: It appears that corporations, partnerships and tax shelters required to use the accrual method under §§447 or 448(a)(3) should still qualify to use one of these simplified methods for determining costs to be capitalized or inventoried since there appears no prohibition on using a simplified method for determining capitalized or inventoried costs under the accrual method prescribed by these sections.

b. Preproductive Period

The preproductive period of plants is deemed to begin when the plant or seed is first planted or acquired by the taxpayer and end when the plant becomes productive or sold. The preproductive period of animals begins at the time of acquisition, breeding or embryo implantation, and ends when the animal is ready to perform its intended function. For example, the productive period of a cow used for breeding ends when the first cow is dropped.[46] The preproductive period in the case of a plant or animal that will have more than one yield is the period before the first marketable crop or yield of the plant or animal. In the case of any other plant or animal, it will be the period before the plant or animal is reasonably expected to be disposed of.[47]

[34] Senate Report at 142. See also the simplified rules for retailers and wholesalers discussed below.

[35] Senate Report at 142. *See* Regs. §1.471-11(d)(6)(ii).

[36] The Finance Committee specifically stated that storage costs incurred by a manufacturer following completion, or substantial completion, of the manufacturing process will be subject to the capitalization rules and this provision overrules *Heaven Hill Distilleries, Inc. v. U.S.*, 476 F.2d 1327 (Ct. Cl. 1973) and *Van Pickerill & Sons, Inc. v. U.S.*, 445 F.2d 918 (7th Cir. 1971) though it contains no inference as to the validity of those cases under current law. Senate Report at 142 (note 40).

[37] Senate Report at 142.

[38] §263A(c)(2) and (3).

[39] Conference Report at II-305. *See* Regs. §§1.451-3(d)(5)(iii) and 1.451-3(d)(6)(iii).

[40] §263A(c)(4).

[41] Conference Report at II-304.

[42] §263A(d)(1).

[43] Pre-1986 TRA law is retained for the preproductive expenses of growing timber and the above described ornamental trees (*e.g.*, Christmas trees). In addition, pre-TRA 86 law is retained with regard to which costs of growing timber are deductible in the year incurred and which costs must be capitalized. Conference Report at II-304-5.

[44] §263A(d)(2)(A). *See* §278(c) of the 1954 Code, repealed by Act §803(b)(6).

[45] §263A(e)(5). House Report at 629. *See* Regs. §1.471-6.

[46] House Report at 628.

[47] §263A(e)(3)(A). The House Report, p. 628, indicates that animals held for slaughter should not be subject to the uniform capitalization rules.

The use of any supply produced in a farming business by that farming business is treated as a disposition. The preproductive period for commercially grown plants in the United States shall be the nationwide weighted average preproductive period for such plants. The House Ways and Means Committee indicated that the Treasury Department is to periodically publish a list of preproductive periods for various plants produced in the United States in commercial quantities.[48]

B. Election out of Uniform Capitalization Rules for Covered Farmers

There is also a special irrevocable election out of the uniform capitalization rules and interest capitalization rules for all farmers other than those required to use the accrual method of accounting under §§447 or 448(a)(3) and growers of pistachio trees.[49] The election is also not available for costs incurred by citrus and almond grove growers before the close of the fourth taxable year beginning with the year in which the trees were planted.[50]

The price which electing farmers must pay is that their plants and animals are treated as §1245 property and gain upon the sale of a plant or animal will be taxed as ordinary income to the extent of the deductions taken as a result of the election.[51] Electing farmers and ranchers should be allowed to estimate the amount of preproductive period expenses subject to recapture under one of the simplified methods permitted to accrual method farmers under current law as non-electing farmers are allowed to use such methods for estimating expenses which are to be capitalized.[52]

The farmer (and parties related to him) must also depreciate all property predominately used in the farming business and placed in service in any taxable year in which the election is in effect based on the alternative depreciation method in Code §168(g). That method allows only straight line depreciation over the class life of most property, over 12 years for personal property with no class life, and over 40 years for real property.[53] Related parties include family members (spouse and minor children), corporations owned 50% or more by the taxpayer and members of his family, corporations in the same controlled group as described in §1563(a)(1), and partnerships owned 50% or more by the taxpayer and members of his family.

Comment: As a result of this provision and the irrevocability of the election, farmers who consider this election should be careful to determine if an election under §263A(d)(3) may adversely affect the depreciation of any related parties.

The election may be made only for the first taxable years which begins after December 31, 1986 and during which the taxpayer is a farmer.[54]

[48] House Report at 628.
[49] §263A(d)(3).
[50] If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting. House Report at 629. This provision replaces 1954 Code §278, repealed by Act §803(b)(6).
[51] §263A(e)(1).
[52] House Report at 630. *See* Regs. §1.471-6.
[53] §263A(e)(2).
[54] §263A(d)(3)(D).

1. Exception for Small Retailers and Wholesalers

Taxpayers who acquire property for resale (generally retailers and wholesalers) will not be subject to the more stringent allocation rules if their average annual gross receipts for the three preceding taxable years are $10,000,000 or less.[55] Aggregation rules similar to those in §448(c)(2) and (3) will apply to assure that related entities are treated as one taxpayer for purposes of determining qualification for this exemption.

Comment: Definitions which are developed in connection with §448(c) will probably be helpful in determining the definitions of provisions in this section.

2. Simplified Capitalization Method for Retailers and Wholesalers

The Conference Report directs the Treasury to prescribe elective rules for simplified uniform capitalization rules for taxpayers which acquire property for resale.[56] There is no current information on the manner in which this election is made. If a taxpayer acquiring property for resale does not elect this simplified method, it must apply the new uniform capitalization rules to that property under the same procedures and methods applicable to manufacturers. The Treasury Department is allowed to prescribe other methods of applying the uniform capitalization rules to taxpayers acquiring property for resale. Once the taxpayer has chosen the simplified method or method applicable to manufacturers, it must obtain the permission of the IRS to change its election.[57] The method applies not only to the taxpayer's operations in all succeeding taxable years, but also in the restatement of its beginning inventory balance on its first taxable year beginning after December 31, 1986.[58]

The Conference Report (II-305) states that the simplified method provided under Treasury's rules and regulations should generally follow the examples described in the Report (discussed below), and that, until rules or regulations are issued, taxpayers may rely on these examples.

The initial calculation of inventory for this elective simplified method will be without regard to the new capitalization rules. Taxpayers will then add an amount calculated in accordance with the simplified rules to the amount of ending inventory calculated under the old rules. For taxpayers using the last-in, first-out (LIFO) method, they will first determine their ending LIFO inventory without regard to the new inventory rules, and will then add the additional costs determined under the simplified method to their existing LIFO layers. Similarly, taxpayers using the first-in, first-out (FIFO) method which do not sell their entire beginning inventory must add a proportionate part of costs previously added under the simplified rules to the amount of beginning inventory in the ending inventory. The simplified method will be applied to each separate trade or business of a taxpayer.

Comment: By retaining the old capitalization rules in this situation for purposes of the new rules, Congress, and the regulations which the Treasury Department will eventu-

[55] §263A(b)(2)(B).
[56] §263A(h)(2).
[57] Conference Report at II-305.
[58] Conference Report at II-308.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ally release, may greatly complicate the tax accounting of retailers and wholesalers which must determine if this simplified method is beneficial.

The Conference Report (II-306), provides four categories of costs will be allocable to inventory under the simplified rules:

(a) offsite storage and warehousing costs of a facility whose primary function is the storage or warehousing of goods (including rent or depreciation attributable to a warehouse, property taxes, insurance premiums, security costs and other costs directly identifiable with the storage facility);

(b) purchasing costs, such as buyer's wages or salaries;

(c) handling, processing, assembly, repacking and similar costs including labor costs attributable to unloading goods (but not including labor costs attributable to loading of goods for final shipment to customers, or labor at a retail facility); and

(d) the portion of general and administrative costs allocable to these functions.

Storage costs will be allocated to ending inventory based on the ratio of total storage costs for the year to the sum of (1) the beginning inventory balance and (2) gross purchases during the year. If a taxpayer has $2,000,000 of beginning inventory, $8,000,000 of purchases during the year and storage costs of $1,000,000 for the year, 10%of the value of ending inventory will be added to ending inventory for storage costs ($1,000,000 ÷ ($2,000,000 + $8,000,000)). Accordingly, if the taxpayer's ending inventory is $3,000,000, then $300,000 will be added to ending inventory to account for storage costs; the remaining $700,000 of storage costs will be deducted as part of cost of sales. For a LIFO basis taxpayer, an addition for storage costs would only be made if there was an increase in ending inventory over beginning inventory. If there were an increase in ending inventory of $1,000,000 in the current period, then, based on the preceding example, $100,000 of cost (.10 × $1,000,000) would be added to the LIFO layer for the current year.

Purchasing costs are allocated between inventory costs and costs of goods sold based on the ratio of purchasing costs to gross purchases. Using the example in the prior paragraph, if the taxpayer incurred $500,000 of purchasing costs, its purchasing cost allocation factor would be 6.25% ($500,000 ÷ $8,000,000). Thus, in the case of the FIFO basis taxpayer above, $187,500 (.0625 × $3,000,000) of purchasing costs would be allocated to ending inventory and the remaining amount would be added to costs of sales and currently deducted. The LIFO basis taxpayer above would add $62,500 (.0625 × $1,000,000) to the LIFO layer for the increase in inventory in the current year.

Processing, repackaging and other similar costs are allocated based on the ratio of total processing, repacking and similar costs to the sum of (1) the beginning inventory balance, and (2) gross purchases during the year. This is the same calculation as required for allocation of storage costs described above. The Conference Report indicates that in allocating labor costs between inventoriable and noninventoriable functions, the taxpayer may use any reasonable method. It did not intend that detailed records establishing the amount of time spent by an employee on a particular function would be required to substantiate the allocation. If records, however, were available, they should be used in making the allocation.[59]

General and administrative expenses that are allocable in part to storage, purchasing and processing activities and in part to activities for which no capitalization is required are allocated based on the ratio of direct labor costs incurred in a particular function to gross payroll costs. Using the examples contained in the prior paragraphs concerning this subject, allocation would be required for the taxpayer's accounting department costs of $75,000 to the storage, and purchasing costs. Of the total costs for these functions, direct labor payroll represents $250,000, and $500,000, respectively, and gross payroll is $1,500,000 for the tax year. The apportionment of accounting costs to the storage function will be $12,500 ($75,000 × ($250,000 ÷ $1,500,000)) and to the purchasing function would be $25,000 ($75,000 × ($500,000 ÷ $1,500,000)).

3. Interest Capitalization

Interest on debt is not treated as a cost allocable to inventory or items produced by the taxpayer under the uniform capitalization rules discussed above. However, interest paid or incurred during the production period must be capitalized for indebtedness directly attributable to production expenditures with respect to real or tangible personal property produced by a taxpayer, or for indebtedness that could have been reduced if production expenditures had not been incurred.[60] Also, interest on indebtedness incurred or continued in connection with property used to produce property to which §263A(f) applies will be subject to this limitation.[61]

The production expenditures which are covered by this section are those for property which have (1) an estimated production period exceeding two years, (2) an estimated production period exceeding one year if its cost exceeds $1,000,000, or (3) real property or property with a class life of 20 years or more (as determined in §168).[62] The interest capitalization rules do not apply to a residence constructed by the taxpayer.[63]

The production period begins when construction or production commences and ends when the property is ready to be placed in service or is ready to be held for sale.[64] The

[59] Conference Report at II-306, note 5.

[60] §263A(f)(1) and (2). Production expenditures include cumulative production costs (including previously capitalized interest) required to be capitalized. Senate Report at 144 (note 44).

[61] §263A(f)(3). This is true even if the cost of that asset is not fully reflected in inventory or cost of sales. If the asset is partially used for production and partially for other purposes, only the portion of interest allocable to production must be capitalized. Senate Report at 144.

[62] §263A(f)(1) and (4)(A). The Act does not consider that certain property produced by taxpayers may have class lives both above and below the 20 year threshold depending on its use by the purchaser. Staff on the Senate Finance Committee have indicated that if the taxpayer knows of the intended use of the property, it will classify the property based on that knowledge. If the property is produced for inventory, the taxpayer should determine how its inventory is used and capitalize interest based on that portion of inventory which will have a class life of 20 years or more. This seems extremely complicated and taxpayers may be well advised to await further clarification of this problem in regulations.

[63] §263A(f)(2)(b).

[64] §263A(f)(4)(B). Planning and design activities do not generally cause the production period to begin, however, the production period will include

determination of whether interest is incurred or continued for the production of property should be similar to the rules under current §189 (which have yet to be issued in regulations).[65] Taxpayers which produce property under a long-term contract must capitalize interest costs to the extent that income is not reported under the percentage of completion method.[66]

Debt that can be specifically traced to construction or production expenditures for property is first allocated to that property. If construction or production expenditures exceed the amount of that debt, then interest on other debt of the taxpayer will be attributed to such construction or production.[67] The assumed rate of interest which cannot be deducted will be calculated at the average rate of interest on the taxpayer's outstanding debt (excluding debt specifically traceable to production or construction expenditures). This method of allocating interest must be used even though Financial Accounting Standards Board Statement 34 or a regulatory authority for a utility may not allow this method for financial or regulatory accounting purposes.[68] The regulations will be drafted to preclude avoiding this allocation through the use of related parties.[69]

Example: If a debt-free wholly-owned subsidiary constructs property subject to §263A(f), then a portion of any debt of the parent will be subject to the restriction on deduction.

For flow-through entities (partnerships, S corporations and trusts), the rules are applied first at the level of the entity constructing the property and then at the owner level to the extent that the flow-through entity does not have sufficient debt to support the production or construction expenditures.[70] If construction is for a particular customer who makes progress or advance payments, the customer is treated as constructing the asset. Thus interest payments attributable to the payments to the contractor are subject to the interest deduction restriction.[71] The contractor will still be subject to the interest deduction restriction to the extent progress or advance payments do not cover the accumulated contract costs.[72]

4. *Property Purchase and Disposition Tax Capitalization*

As part of the repeal of the current individual deduction for state and local sales taxes, the 1986 TRA provides that any taxes (other than state, local and foreign real property, personal property, income, war profits, and excess profits taxes and the windfall profit tax in §4986) imposed upon the acquisition or disposition of property shall be treated as part of the acquisition cost or a reduction in the proceeds received upon the property's disposition.[73] Accordingly, sales taxes will now be capitalized as part of the cost of goods sold in the business of a taxpayer, and real property transfer taxes will be added to the basis of a purchaser and will reduce the gain of a seller.

C. *Effective Dates and Transition Rules*

In general, the uniform capitalization rules are effective for costs and interest paid or incurred after December 31, 1986, in taxable years ending after that date.[74] However, there is an exception for self-constructed assets with respect to which substantial construction had occurred prior to March 1, 1986.[75] Costs and interest of such assets will remain subject to the current tax accounting rules. The change in the capitalization of taxes will also be effective for taxable years beginning after December 31, 1986.[76]

For fiscal year taxpayers which have inventories, the effective date is delayed until the first taxable year beginning after December 31, 1986. All taxpayers with inventories are required to restate their inventory balances as of the beginning of the first taxable year beginning after December 31, 1986 as if the uniform capitalization rules had been in effect for all prior periods.[77] In effect, beginning inventory must be revalued to reflect the greater deferral of production costs under the new rules. To the extent that the information to make such a determination is not available, the Treasury Department is directed to issue regulations or rulings which permit a taxpayer to estimate the amount by which inventory will be revalued by using available data.[78]

For example, a FIFO basis taxpayer (or LIFO basis taxpayer using the specific identification method) who has information on the increase in production costs deferred for recent periods for an item, but not for earlier years, may use the increase in recent periods as an estimate of the increase in prior years.[79] The illustrations in the Senate Report indicate that the increase calculated for current years is not just a straight average of the increases in current years, but is an average weighted by the number of items in the ending inventory from those current years.[80] If a LIFO basis taxpayer does not have information for production of an item in early years but does have information on a class of similar items only in recent years, the taxpayer may use the information for the class of similar

---

the period to age a product prior to sale (*e.g.* wine and liquor). Senate Report at 144.

[65] Senate Report at 144.

[66] Conference Report at II-309.

[67] §263A(f)(2)(A).

[68] Conference Report at II-309.

[69] Senate Report at 144.

[70] §263A(f)(2)(C).

[71] §263A(g)(2).

[72] Senate Report at 145.

[73] Act §134(a); §164(a).

[74] Act §803(d)(1).

[75] Act §803(d)(3).

[76] Act §151(a).

[77] Act §803(d)(2). Senate Report at 146-7. There is no restatement of beginning balances and no §481 adjustment for property which is held in the ordinary course of business but which is not inventory. Senate Report at 146. *See W.C. & A.N. Miller Development v. Comr.*, 81 T.C. 619 (1983).

[78] Senate Report at 147.

[79] Senate Report at 147.

[80] Assume that the number of items in ending inventory for a product by year of production are: 1983-150, 1984-100, 1985-100, and 1986-50; and the original and revised production costs are: 1983-$5.00 and unavailable, 1984-$6.00 and $7.00, 1985-$6.50 and $7.75, and 1986-$7.00 and $9.00. The weighted average increase in the production costs attributable to 1983 will be calculated as follows:

[(100 × ($7.00 - $6.00)) + (100 × ($7.75 - $6.50)) + (50 × ($9.00 - $7.00))] ÷ [(100 × $6.00) + (100 × $6.50) + (50 × $7.00)]. The weighted average increase during the period is 20.31%. Thus the value of the inventory would be as follows:

1983 - 150 × $5.00 × 1.2031 = $902.33
1984 - 100 × $7.00 = $700.00
1985 - 100 × $7.75 = $775.00
1986 - 50 × $9.00 = $450.00

items in recent years as its estimate of the increase in earlier years. A weighted average cost must also be used and this average must be weighted by the value of the items in inventory.[81]

Taxpayers who use the dollar-value LIFO method of accounting have more information to retrieve to revalue all of their prior LIFO layers, and thus, recognizing that such a reconstruction may not be possible, the Senate Report permits such taxpayers to revalue all of their LIFO layers under the new absorption rules by computing the change in current costs as a result of the new absorption rules for the three most recent tax years for which the taxpayer has sufficient information.[82] The taxpayer would then apply that percentage to restate the costs of the beginning LIFO inventory value of the entire pool for the year of the change. The year prior to the year of the change would become the new base year and current costs for that year are to be used for extension purposes in future taxable years. The percentage change is only applied to the base year costs of the inventory and not to the LIFO index for that year. If the taxpayer had sufficient information, the proper method to calculate the change in its LIFO inventory would be to redetermine the base year cost using the new absorption rules, and then recalculate the LIFO index for each ensuing year using the new absorption rules. To the extent that the taxpayer can show that costs which contributed to the average revaluation factor could not have affected a prior year, the revaluation factor applied to that year may be adjusted by an appropriate amount.

Example: A calendar year taxpayer first adopted the dollar value method in 1981 using a single pool and the double extension method. The taxpayer's beginning LIFO inventory for the year of change is as follows:

Base Year	Base Year Cost	Index	LIFO Carrying Value
	$14,000	1.00	$14,000
1981	4,000	1.20	4,800
1982	5,000	1.30	6,500
1983	2,000	1.35	2,700
1984	-0-	1.40	-0-
1985	4,000	1.50	6,000
1986	5,000	1.60	8,000
TOTAL	$34,000	—	$42,000

The taxpayer recomputes its inventoriable costs under the new capitalization rules for the ending LIFO layers for the three preceding taxable years as follows:

	Recorded Cost	Adjusted Cost	Percentage Change
1983	$ 35,000	$ 45,150	.29
1984	43,500	54,375	.25
1985	54,400	70,720	.30
TOTAL	$132,900	$170,245	.28

Applying the average revaluation factor to each layer of inventory, it is restated as follows:

Base Year	Base Year Cost	Index	LIFO Carrying Value
	$17,920	1.00	$17,920
1981	5,120	1.20	6,144
1982	6,400	1.30	8,320
1983	2,560	1.35	3,456
1984	-0-	1.40	-0-
1985	5,120	1.50	7,680
1986	6,400	1.60	10,240
TOTAL	$43,520	—	$53,760

The positive §481 adjustment is $11,760 ($53,760 - $42,000). Restatement of the inventory to reflect the year of change as a new base year will produce the following result:

Base Year	Base Year Cost	Index	LIFO Carrying Value
	$28,672	.625	$17,920
1981	8,192	.75	6,144
1982	10,272	.81	8,320
1983	4,114	.84	3,456
1984	-0-	.875	-0-
1985	8,170	.94	7,680
1986	10,240	1.00	10,240
TOTAL	$69,660	—	$53,760

Comment: The bill's "shortcut" method for making this determination may provide a reasonable estimate of a more arduous calculation.

The increase in the inventory value resulting from this change, *i.e.*, the §481 adjustment, will be spread over the period which the taxpayer has used inventories or four years, whichever is less.[83] The timing for inclusion of the §481 adjustment in income will be governed by Rev. Proc. 84-74.[84] The Conference Report states that any positive §481 adjustment will be allowed to offset net operating loss and tax credit carryforwards, and that for purposes of determining estimated tax payments, the adjustment will be recognized ratably throughout the year.[85]

[81] Senate Report at 149.

[82] The taxpayer has the option of using as many additional consecutive prior years as it desires. Senate Report at 152. Any taxpayer (manufacturer, producer, retailer, or wholesaler) using the dollar-value LIFO method may use the three-year look-back procedure irrespective of the data available to the taxpayer for determining revaluation of prior LIFO layers. Announcement 87-5, 1987-4 I.R.B. ---- (1/27/87).

[83] Act §803(d)(2)(B).

[84] 1984-2 C.B. 736. Conference Report at II-308.

[85] Conference Report at II-308.

If a taxpayer elects to use the simplified method of determining allocable costs, it must use that method in restating its beginning inventory value. LIFO basis taxpayers who lack sufficient data to precisely compute the §481 adjustment may use the method of approximation available to manufacturers as specified above.[86] The IRS has noted that this requirement may involve using information from a year in which no LIFO increment occured.[87] There is no restatement required for property which is held for sale to customers primarily in the ordinary course of business but which is not inventory.[88]

[86] *See* fn 82 *supra.*

[87] I.R. 87-5, 1987-4 I.R.B. —— (1/26/87), *see* Senate Report at 150, Ex. 2.

[88] Senate Report at 146. *See, e.g., W.C. & A.N. Miller Development v. Comr.*, 81 T.C. 619 (1983).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 20

LIMITATIONS ON COMPLETED CONTRACT METHOD

Charles E. Taylor, Esq.
Silverstein and Mullens
Washington, D.C.

I. Pre-1986 TRA Law

If a manufacturer or contractor produces non-inventory goods for a customer and the contract qualifies as a long-term contract (*i.e.* a building, installation, construction or manufacturing contract which is not completed by the end of the taxable year that it is entered into), it can use the completed contract or percentage of completion methods as well as the cash or accrual methods to account for the income and expense of the contract.[1] A manufacturing contract qualifies, however, only if it involves the manufacture of either unique items of a type not normally carried in the finished goods inventory of the taxpayer, or items normally requiring more than 12 months to complete.[2]

Under the percentage of completion method, income is recognized according to the portion of the contract that is completed in each year.[3] The percentage of completion can be determined by either comparing the costs incurred as of the end of the taxable year to the total estimated costs to be incurred upon the completion of the contract, or comparing the work performed on the contract as of the end of the taxable year with the estimated total work to be performed.[4] All costs incurred for the contract are deductible in the year in which they are incurred although a contractor must maintain inventories for materials and supplies. Regs. §1.451-3(c)(3).

Under the completed contract method, the entire contract price is included in income in the year in which the contract is completed. All costs which are properly allocated to the contract are deducted in that year.[5]

Regulations adopted in 1976 provide detailed rules for the allocation of contract costs.[6] These costing rules essentially parallel the full absorption rules, except that, under the completed contract method, most financial conformity costs (*i.e.*, Category 3 costs) must be treated as contract costs. Thus, unless a contract is subject to the "extended period long-term contract" rules described below, the following costs are not contract costs: marketing and selling expenses (including the cost of developing bids); advertising expenses; distribution expenses; interest; general and administrative expenses attributable to the performance of services that benefit the contractor's activities as a whole (*e.g.*, payroll, legal, and accounting expenses); research and experimental expenses under §174; losses under §165; percentage depletion in excess of cost depletion; depreciation and amortization reported for tax purposes over that reported on financial statements; income taxes attributable to income received from long-term contracts; pension and profit-sharing contributions and other employee benefits (whether representing past or current service costs); costs attributable to strikes, rework labor, scrap, and spoilage; and salaries of officers that benefit the contractor's activities as a whole.

In 1982,[7] Congress directed Treasury to modify the rules relating to allocation of costs to long-term contracts. In the case of "extended period" long-term contracts — those that are not expected to be completed within 24 months from the contract commencement date — certain costs previously not treated as contract costs must be allocated to the contracts to the extent they either directly benefit or were incurred by reason of such contracts. These costs include, *inter alia*,:

(1) bidding expenses on contracts awarded to the taxpayer;

(2) repair expenses of equipment or facilities;

(3) general and administrative expenses properly allocable to long-term contracts under regulations;

(4) research and development expenses that either are directly attributable to particular long-term contracts existing when the expenses are incurred, or are incurred under an agreement to perform research and development;

(5) depreciation, capital cost recovery, and amortization for equipment and facilities currently being used in the performance of extended period long-term contracts, in excess of amounts reported for financial accounting purposes;

---

[1] The cash method of accounting is not available to taxpayers who are required to maintain inventories. However, if it clearly reflects income, the theoretical contractor who has no inventories can use the cash method. *See* H.R. Rep. No. 426, 99th Cong., 1st Sess., p. 619 (1985) (hereinafter referred to as "House Report").

[2] Regs. §1.451-3(b)(1)(ii). All section references in this Chapter are to the Internal Revenue Code of 1986, and the regulations thereunder.

[3] Regs. §1.451-3(c)(1).

[4] Regs. §1.451-3(c)(2).

[5] Regs. §1.451-3(d)(1).

[6] Regs. §1.451-3(d)(5).

[7] Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, §229 (hereinafter referred to as "TEFRA").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(6) pension and profit-sharing contributions representing current service costs, and other employee benefits;

(7) rework labor, scrap, and spoilage; and

(8) depletion (whether or not in excess of cost depletion).[8]

The principal distinctions between the treatment of long-term contracts and the treatment of extended period long-term contracts involve: the deductibility of depreciation (in the case of assets used in the performance of particular long-term contracts, only book depreciation must be allocated to contracts in the former, whereas all such depreciation must be allocated to contracts in the latter); the deductibility of current-service pension costs (deductible for the former if beneficial to the taxpayer's activities as a whole, but in most instances partially allocable to the contract for the latter) and the deductibility of research and experimental costs (deductible for the former, but treated as contract costs for the latter if directly resulted to a particular contract or incurred under an agreement to perform research). In addition, rework labor, scrap, and spoilage costs are allocated to the contract in the case of extended period long-term contracts, but not for other long-term contracts.

An exception to the extended period long-term contract rules is provided for contracts for the construction of real property if the contract is expected to be completed within three years, or if the contractor's average annual gross receipts for the three taxable years preceding the year of the contract do not exceed $25,000,000.[9] The regulations as adopted in 1976 continue to apply to these construction contracts and to all other long-term contracts expected to be completed within two years.

The legislative history of TEFRA expresses Congress' intention that the portion of the taxpayer's general and administrative expenses that directly benefits extended period long-term contracts must be allocated to such contracts, even though the same type of costs also benefits other activities of the taxpayer. However, general and administrative expenses that are incurred in the operation of the taxpayer's general management or policy guidance functions (for example, salaries of financial officers) are currently deductible.[10]

Consistent with the TEFRA legislative history, the regulations adopt an expansive view of general and administrative expenses that directly benefit extended period long-term contracts and therefore must be allocated to such long-term contracts. Example of the types of functions the cost of which ordinarily are required to be allocated include administration of manufacturing or construction projects, personnel operations, purchasing operations, materials handling and warehousing operations, accounting and data services operations related to contract activities, data processing, security services, and legal departments that provide legal services with respect to contracts.[11] Functions for which allocation of costs ordinarily are not required include overall management and policy guidance (*e.g.*, services by the board of directors and the chief executive, financial, legal, and accounting officers if no substantial part of their services, relate to a particular contract), general financial planning and management, financial accounting, tax services, public relations, and internal audit.[12]

II. Overview

The Act generally repeals the use of the completed contract and accrual methods of accounting for long-term contracts and substitutes the use of the percentage of completion-capitalized cost method ("40% PCM method").[13] Contracts for construction or improvement of real property may still use the completed contract method and may allocate costs based on the regulations applicable to non-extended period long-term contracts if the contracts are estimated to be completed within two years from the commencement date of the contract and are performed by a contractor whose average annual gross receipts for the three years preceding the taxable year in which the contract was made do not exceed $10,000,000.[14] However, allocation is not required for independent research and development expenses expenses for unsuccessful bids and proposals, and marketing, selling and advertising costs. In addition, a taxpayer must capitalize any costs which it identifies as attributable to the contract pursuant to a cost-plus contract or pursuant to a contract for which costs are certified under federal statute or regulations.

III. Detailed Analysis

The Act generally repeals the use of the completed contract and accrual methods of accounting for long-term contracts and substitutes the use of the percentage of completion-capitalized cost method ("40% PCM method"), described below.[15] The definition of a long-term contract is unchanged from pre-1986 TRA law (*i.e.*, any contract for the manufacture, building, installation or construction of property if such contract is not completed within the taxable in which it is entered into).[16] Taxpayers who continue to use the percentage of completion method are subject to the look-back rule described below.[17]

A. Percentage of Completion-Capitalized Cost ("40% PCM") Method

The 40% PCM method requires that a taxpayer take into account 40% of items with respect to a contract on the percentage of completion method. In a change from pre-1986 TRA law, the percentage of completion is determined by comparing total contact costs incurred before the close of the taxable year with estimated total contract costs.[18]

[8] T. D. 8067, 51 Fed. Reg. 376 (January 6, 1986); Regs. §1.451-3(d)(6).
[9] Regs. §1.451-3(b)(3)(ii).
[10] S. Rep. 530, 97th Cong., 2d. Sess., 547 (1982).
[11] Regs. §1.451-3(d)(9)(vi).
[12] Regs. §1.451-3(d)(9)(vii).
[13] Act §804, adding Code §460.
[14] Act §804, adding §460(e).
[15] §460(a)(1).
[16] §460(f). H.R. Rep. No. 841, 99th Cong. 2d Sess., p. II-311 (1986) ("Conf. Rep."). Manufacturing contracts still must be for a unique item which is not normally in a contractor's finished goods inventory or normally require more than 12 calendar months to complete. The Treasury Department has the power to prescribe regulations for severing and aggregating contracts. *See* Regs. §1.451-3(e).
[17] §460(b)(1) and (3).
[18] §460(b)(2)(A). *See* footnote 4 and accompanying text for pre-1986 TRA rules for the methods of determining percentage of completion.

The contractor will multiply the total contract price and all costs allocable to the contract by the percentage of completion and will include 40% of those amounts as income and expense, respectively, less any amount included in income or deducted as expense in prior taxable years. Thus, 40% of the profit or loss from the contract will be recognized over the period of the contract. The remaining 60% of income and expense of the contract are to be accounted for under the contractor's normal method of accounting (*e.g.*, the completed contract or accrual method).

Example: If a taxpayer uses the accrual shipment method of accounting for long-term contracts, 60% of the gross income will be recognized upon shipment of the subject of the contract and 60% of the costs will be deducted at that time.

The costs allocated to a contract are those (including research and experimental costs) which directly benefit, or are incurred by reason of, the long-term contract activities of the contractor in the same manner as costs are allocated to extended-period long-term contracts under §451 and the regulations thereunder.[19] Independent research and development expenses, marketing, selling, and advertising expenses, and unsuccessful bid and proposal costs, are exempt from the allocation requirement.[20] A taxpayer must also allocate to a contract any costs for cost-plus or federal long-term contracts which it (or a related party) identifies as attributable to the contract by its terms or by federal, state or local law or regulations.[21] A federal long-term contract is any long-term contract (or subcontract) to which the United States or any agency of instrumentality thereof is a party.[22]

Example: General and administrative costs attributable to cost-plus contracts and to federal government contracts requiring certification of costs are treated as contract costs. This is true even though the costs may be deductible under existing regulations.[23]

The independent research and development expenses which are not to be allocated to long-term contracts are those incurred in the performance of independent research and development other than (1) expenses directly attributable to a long-term contract in existence when the expenses are incurred, or (2) any expense under an agreement to perform research or development (including any costs which qualify as independent research and development costs under the Federal Acquisition Regulations System).[24] However, the Conference Report specifies that the contractual arrangement regarding independent research and development shall not be severed from a long-term contract in such a manner as to render such costs ineligible for treatment as costs of a long-term contract or to accelerate the recognition of any income relating to those costs when compared with the amount of income that would be recognized under the contractor's regular method of accounting.[25] According to the Conference Report at II-312, this change expressly overrules the position of the IRS in several recent technical advice memoranda.

Observation: Contractors should carefully review the decision to use the 40% PCM method. For alternative minimum tax purposes, the contractor must report income based upon the percentage of completion method. §56(a)(3), as amended by Act §701(a). Thus, a taxpayer may find itself paying alternative minimum tax before completion of a contract and regular tax in the year of contract completion. The contractor will have the benefit of the alternative minimum tax credit carryforward only prospectively and may have a significant acceleration of income tax.

B. Exceptions to Use of 40% PCM Method

Contracts for construction or improvement of real property which are estimated to be completed within two years from the commencement date of the contract and are performed by a contractor whose average annual gross receipts for the three years preceding the taxable years in which the contract was entered into do not exceed $10,000,000 may still use the completed contract method and may allocate costs based on the regulations applicable to non-extended period long-term contracts as under pre-1986 TRA law.[26] To preclude avoidance of the restrictions on the completed contract method by use of multiple related entities, gross receipts of all trades or businesses (whether or not incorporated) which are under common control with the taxpayer within the meaning of §52(b), and all members of any controlled group of corporations of which the taxpayer is a member will be aggregated. A controlled group of corporations will have the same meaning as in §1563(a), except that a 50% requirement will be substituted for the 80% requirement in §1563(a)(1), and §1563(a)(4) and (e)(3)(C) shall be disregarded.[27]

Treasury is also to prescribe regulations for attribution of gross receipts of taxpayers who engage in construction contracts through partnerships, joint ventures and corporations.[28]

Contracts eligible for the small construction contract exception will remain subject to the pre-1986 TRA rules (*i.e.*, the regulations applicable to non-extended period long-term contracts).[29] Since such contracts involve the construction of real property, they are subject to the interest capitalization rules without regard to their duration.[30]

C. Percentage of Completion Look-Back Method

The Act contains a look-back provision with respect to any portion of a contract accounted for on either the 100% or 40% percentage of completion method.[31] Upon completion of the contract, the contractor computes the income

[19] §460(c)(1). These cost allocations are are also used to determine the percentage of completion of a contract. Conf. Rep. at II-311.

[20] §460(c)(4). Bid and proposal costs may be treated as unsuccessful for this purpose only after the taxpayer has withdrawn its bid or the contract has been awarded to another person. S. Rep. No. 313, 99th Cong., 2nd Sess., p. 145 (footnote 45) (1986) ("Sen. Rep.").

[21] §460(c)(2).

[22] §460(d). The rules of §168(h)(2)(D) which treat certain taxable entities as not being instrumentalities of the United States are applicable in this situation.

[23] Conf. Rep. at II-311.

[24] 48 C.F.R. §31.205-18(1985). §460(c)(5); Conf. Rep. at II-311.

[25] Conf. Rep. at II-312.

[26] *See* Regs. §1.451-3(d)(5); §460(e)(1).

[27] §460(e)(3).

[28] §460(e)(2).

[29] Conf. Rep. at II-312-3.

[30] *Id.*

[31] §460(b)(3).

which should have been reported in all of the years of the contract if actual total contract costs had been used instead of estimated total contract costs. To the extent the contractor included too large an estimate of the total contract costs, the government is due interest from the contractor on the imputed underpayment of tax from that taxable year until the year in which the tax on the contract is finally paid. Likewise, if the contractor underestimated the total costs of completing the contract, the contractor is due a refund of interest on the overpayment of income tax from the government from that taxable year until the year in which the tax on the contract is finally paid. Regardless of who is owed interest, the interest will be computed using the overpayment rate (*i.e.*, the lower rate) in §6621 and amended by TRA 1986.[32]

D. Interest Allocations

In general, interest attributed to long-term contracts must be allocated to the contract in the same manner as interest costs are allocated to property produced by the taxpayer under §263A(f).[33] Interest allocation is required for the small construction contracts which are exempt from the stricter allocation requirements of non-interest costs.[34] For purposes of determining if costs exceed the *de minimis* rule of §263A(f)(1)(B)(iii) and require capitalization of interest, the costs shall be determined on a contract by contract basis.[35] However, where taxpayers use the accrual method of accounting for long-term contracts, §263A (f)(1)(B)(iii) will be applied on a property-by-property basis.[36]

In applying §263A(f) for purposes of §460(c)(3)(A), the production period is the period beginning on the later of the contract commencement date (as defined in §460(g)), or if the taxpayer uses the accrual method with respect to long-term contracts, the date by which at least 5% of the total estimated costs (including design and planning costs) under the contract have been incurred.[37] The production period ends on the contract completion date.[38]

Comment: Because there is current deduction of all costs related to a contract accounted for on the percentage of completion method, there is effectively no capitalization of interest required for such contracts.[39]

E. Effective Date

The provisions of the Act are effective for long-term contracts entered into after February 28, 1986.[40]

For periods on, or after October 22, 1986, any independent research and development expenses taken into account in determining the total contract price are not be severable from the contract, and any independent research and development expenses are not be treated as amounts chargeable to capital account.[41]

---

[32] §460(b)(3)(C).

[33] §460(c)(3)(A). *See* Chapter 19, *supra*, for a more complete discussion of interest capitalization required by §263A.

[34] Conf. Rep. at II-313.

[35] §460(c)(3)(C).

[36] *Id.*

[37] §460(c)(3)(B).

[38] *Id.*

[39] *See* Sen. Rep. at 145.

[40] Act §804(d)(1).

[41] Act §804(d)(2)(A). Note that there is a typographical error in the Act which refers to the definition of independent research and development expenses in §263A(c)(5). That reference should be to §460(c)(5).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 21

SIMPLIFICATION OF DOLLAR-VALUE LIFO METHOD FOR SMALL TAXPAYERS

Charles E. Taylor, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. Background

If the production, purchase or sale of merchandise is a material income producing factor to a taxpayer, the taxpayer must maintain inventories. If inventories are required to be maintained, a taxpayer must generally use the accrual method unless otherwise authorized by the Commissioner.[1] Acceptable methods of accounting for inventories include specific identification, first-in, first-out (FIFO), last-in, first-out (LIFO), and, in certain limited circumstances, average cost.[2]

One method of applying the LIFO method to inventories is the dollar-value method.[3] Under the dollar-value LIFO method, the taxpayer accounts for its inventories on the basis of a pool of dollars rather than on an item-by-item basis.[4] Each pool of dollars includes the value of a number of different types of inventory items. Generally, for wholesalers, retailers, jobbers and distributors, items of inventory are pooled by major lines, types or classes of goods.[5] In the case of manufacturers, all inventory items which represent a natural business unit may be combined into a single pool.[6] Similarly, taxpayers may assign inventory items to one of a number of pools determined by the similarity of the different types of items to each other.[7] A taxpayer with average annual gross receipts of no more than $2,000,000 for its three most recent taxable years may elect to use a single pool for all items of inventory.[8]

The dollar-value LIFO method measures each pool of dollars in terms of the equivalent dollar value of the inventory at the time each portion of the pool of dollars is first added to the inventory account. In order to measure the pool of dollars in terms of equivalent dollar values, the use of the dollar-value LIFO method requires the development of an index which will discount current dollar values back to the equivalent dollar value in the first year the retailer or wholesaler used the LIFO method (called the "base year"). This is normally done by comparing the dollar amount of inventory items measured in present year prices against the dollar amount of the same inventory items in base year prices (the "double-extension" method).[9] If the wholesaler or retailer obtains the permission of the Internal Revenue Service, however, the index may be developed by comparing the dollar amount of inventory items measured in present year prices against the dollar amount of the same inventory items measured in the immediate prior year's prices. This computation yields an annual index component which, when combined with all prior annual index components, creates a cumulative index which discounts present dollar values back to the equivalent dollar values of the base year (the "link-chain" method).

In place of using actual changes in inventory prices, a taxpayer may use tables of price changes published by the Bureau of Labor Statistics as part of the "Producers Price Index" and "Consumer Price Index" publications to construct the index necessary to determine equivalent dollar values.[10] Use of these tables requires the taxpayer to construct an index specific to itself by taking a weighted average of price changes for specific categories of inventory. A taxpayer with average annual gross receipts for its three most recent taxable years of no more than $2,000,000 may use 100% of the index constructed with the published price changes. Taxpayers with average annual gross receipts above $2,000,000 are limited to an index equal to 80% of the index constructed with the published price changes.[11]

B. Reasons for Change

The LIFO method generally is considered to be an advantageous method of accounting for inventories, particularly when costs are rising. The LIFO method matches the costs of the most recent items manufactured or purchased against current sales receipts. When costs are rising, this results in a higher costs of goods sold, and consequently a lower taxable income.

The House Ways and Means Committee believed that the complexity and greater costs of compliance associated with the LIFO method, including the dollar-value LIFO method, had discouraged some smaller taxpayers from using the LIFO method in accounting for their inventories.

---

[1] Regs. §§1.446-1(c)(2)(i) and 1.446-1(a)(4)(i). All code section references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder, unless otherwise indicated.
[2] *See* §472.
[3] Regs. §1.472-8.
[4] Regs. §1.472-8(a).
[5] Regs. §1.472-8(c).
[6] Regs. §1.472-8(b)(1).
[7] Regs. §1.472-8(b)(3).
[8] Former §474(b).
[9] Regs. §1.472-8(e)(1).
[10] Regs. §1.472-8(e)(3).
[11] Regs. §1.472-8(e)(3)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The Ways and Means Committee believed that the LIFO method should be simplified for smaller taxpayers so that the use of method would be practical for all taxpayers.[12] This has been a continuing concern of Congress in the past several years and appeared to be the impetus for adding §474 (allowing certain small retailers and wholesalers to use a single LIFO dollar value pool) to the Code as part of the Economic Recovery Tax Act of 1981.

II. Overview

The 1986 TRA [13] allows certain small businesses to elect to use a simplified dollar-value LIFO method of inventorying costs. Taxpayers will qualify if they have average annual gross receipts for the preceding three taxable years (or for such portion of the preceding three years that the taxpayer actively engaged in a trade or business) of $5,000,000 or less. There are rules for aggregation of members of a controlled group for purposes of determining if the $5,000,000 threshold is met.

The pools for purposes of this method are the 11 general categories of the Consumer Price Index for all Urban Consumers for retailers using the retail method, or the 15 general categories of the Producers Prices and Price Indexes for Commodity Groupings and Individual Items for all other taxpayers. The change in a category for a year will be the annual price change component in calculating the index. The link change method is used to develop the equivalent dollar value for prior years.

The election may be made without the consent of the IRS and applies to all of a taxpayer's LIFO inventories. The taxpayer may only revoke the election with the consent of the IRS. The election is automatically revoked when the taxpayer exceeds $5,000,000 of average annual gross receipts in the preceding three taxable years. As with any LIFO election, a taxpayer who has written down its existing inventory below cost must restore that write-down to inventory in connection with this election. This method repeals the existing election to use one LIFO pool for the dollar value method of small businesses contained in §474, but allows taxpayers currently using that method to continue doing so.

III. Detailed Analysis

A. General Rule

The Act provides an election for certain small businesses to use a simplified dollar-value LIFO method in accounting for their inventories.[14] The simplified dollar-value LIFO method requires inventories to be grouped into pools in accordance with the major categories of the "Producer Price Indexes" or the "CPI Detailed Report." [15] The change in inventory costs for the pool for the taxable year is determined by the change in the published index from the preceding taxable year in the general category to which the pool relates.[16] The computation of the ending LIFO value of the pool is then made using the dollar-value LIFO method. The House Report indicates that the indices necessary to compute the equivalent dollar values of prior years are to be developed using the link-chain method.[17]

1. Eligible Businesses

A taxpayer is eligible to use the simplified dollar-value LIFO method if its average annual gross receipts for its three preceding taxable years (or for such part of the previous three years that the taxpayer has been actively engaged in a trade or business) do not exceed $5,000,000.[18] For purposes of this provision, rules similar to those in §448(c)(3) should apply in determining gross receipts.[19]

Comment: Based on discussions with staff on the Joint Committee on Taxation, gross receipts probably mean all receipts of a taxpayer and would not exclude investment receipts such as interest and dividends.

In the case of a taxpayer who is a member of a controlled group, all persons who are members of the controlled group are to be treated as a single taxpayer for the purpose of determining average annual gross receipts.[20] A controlled group consists of all persons who would be treated as a single employer under §52.[21]

2. Making the Election

A taxpayer may elect to use the simplified dollar-value LIFO method without the consent of the IRS.[22] The election is to be made at such time and in such manner as the Treasury Department may prescribe by regulations.[23] An election to use the method applies to the year of election and to all succeeding taxable years, unless permission to change to another method is obtained from the IRS, or the taxpayer becomes ineligible to use the simplified dollar-value LIFO method as a result of having exceeded $5,000,000 of average annual gross receipts in the preceding three taxable years.[24] If the taxpayer makes an election to use the simplified dollar-value LIFO method, the method must be used for all the inventories of the taxpayer that are accounted for using a LIFO method.[25]

If the taxpayer previously has used a method of accounting for its inventories which allows the value of the inventories to be written down below cost (*e.g.*, the lower of cost or market method), any amount of such write-down must be restored to income in accordance with §472(d) in the taxable year in which the election is effective.[26]

---

[12] H.R. Rep. No. 426, 99th Cong., 1st Sess. p. 599 (1985), (hereinafter referred to as the "House Report").
[13] P.L. 99-514 ("Act").
[14] Act §802; amended §474.
[15] §§474(b)(1)(A) and 474(b)(3).
[16] §474(b)(1)(B).
[17] House Report at 599.
[18] §474(c).
[19] §474(c); *see also* §448(c)(3)(C).
[20] §474(d)(1).
[21] §474(d)(1)(B).
[22] §474(d)(2)(A).
[23] House Report at 600.
[24] §474(d)(2)(B).
[25] House Report at 600.
[26] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

3. *Computation of Simplified Dollar-Value LIFO Inventories*

a. *General Rule*

The computation of inventory values using the simplified dollar-value LIFO method generally follows the rules provided for computation of inventories using the dollar-value LIFO method in Treasury regulations.[27] However, the simplified dollar-value LIFO method differs from pre-1986 TRA rules with regard to the manner in which inventory items are to be pooled, the use of published indices to determine an annual index component for each pool, and the technique to be used in computing the cumulative index for a pool for any given year.

The simplified dollar-value LIFO method requires the use of multiple pools in order to avoid the construction of a weighted index specific to the taxpayer. Rather than construct such an index, the annual change in costs for the pool as a whole is measured by the change in the published index for the general category. The percentage change for the year in the published index for the general category determines the annual index for the pool.[28]

The simplified dollar-value LIFO method uses the link-chain approach, rather than the double-extension approach, to compute a cumulative index for the purpose of determining equivalent dollar values in prior years.[29]

b. *Composition of Inventory Pools*

The simplified dollar-value LIFO method requires inventory pools to be established based on either the 15 general (2 digit) categories of the "Producers Prices and Price Indexes for Commodity Groupings and Individual Items" (currently "Table 6 — Producer prices and price indices for commodity groupings and individual items, Produces Price Indexes" published monthly by the Bureau of Labor Statistics) or the 11 general categories of the "Consumer Price Index for All Urban Consumers" (currently "Table 3 — Consumer Price Index for All Urban Consumers: Food expenditure categories, U.S. city average, CPI Retailer Report" and "Table 5 — Consumer Price Index for All Urban Consumers: Nonfood expenditures categories, U.S. city average, CPI Detailed Report" published monthly by the Bureau of Labor Statistics) as set forth in Regulations.[30] Retailers using the retail method must use the Consumer Price Index categories and all other taxpayers must use the Producers Price Index categories.[31]

c. *Selection of Index*

The taxpayer must establish which month of its taxable year it will use to measure the annual change in the index for all pools. Once the choice of month is established, another month may not be used unless advance permission to do so is granted by the Secretary of the Treasury. The annual change is measured from the established month in one calendar year to the same month in the next calendar year. If the published index figure which the taxpayer has used to measure annual change in costs for inventory pool is restated by the Bureau of Labor Statics after the taxpayer has filed its return for the taxable year in question, the return shall not be filed again or amended in order to reflect the restatement. Instead, the change in costs for the pool for the next taxable year will be measured with regard to the index figure which was used to measure the change in costs for the prior taxable year as the return was filed, and not the restated value.[32]

d. *Rules Applicable to Year of Change*

The first year for which the simplified dollar-value LIFO method is used will represent a new base year for the purpose of the dollar-value LIFO computation.[33] The base year dollar value of each pool will be the portion of the beginning inventory value for such first year which is attributable to the inventory items represented by such pool.[34]

The computations necessary to convert a taxpayer's inventories to the simplified dollar-value LIFO method will depend upon the method that was used to account for the inventories prior to the year of election. A taxpayer that has been using the FIFO method to value its inventories must establish base year dollar values for each of its pools by assigning the inventory items to their respective pools and combining their values in the ending inventory of the year prior to the election. The combined values of inventory items assigned to a pool constitute the base year layer of the pool for future dollar-value LIFO computations.[35]

A taxpayer that has been using a LIFO method must establish values for each of its pools expressed in base year dollars in generally the same manner as does a taxpayer that has been using the FIFO method. In order to preserve pre-existing LIFO layers, however, the entire value of the inventory is not considered as attributable to the base year as in the case for taxpayers that have been using the FIFO method. Instead, the taxpayer is required to restate the prior years' layers in values expressed in base year (*i.e.*, year prior to election) dollars by comparing the prices at which such goods were added to inventory and determining an index for the layer with reference to the present value of the same inventory items.[36]

---

[27] Regs. §1.472-8(e).

[28] House Report at 600-601; §474(b)(1)(B).

[29] *See* Regs. §1.472-8(e)(3); House Report at 599.

[30] House Report at 601; Regs. §1.472-8(e)(3)(iv). This regulation provides that the 11 categories in the Consumer Price Index are food and beverages; housing, maintenance and repair commodities; fuels (other than gasoline); house furnishings and housekeeping supplies; apparel commodities; private transportation (including gasoline); medical care commodities; entertainment commodities; tobacco products; toilet goods and personal care appliances; and school books and supplies. The 15 categories in the Producers Price Index are farm products; processed food and feeds; textile products and apparel; hides, skin, leather, and related products; fuels and related products and power; chemicals and applied products; rubber and plastic products; lumber and wood products; pulp, paper, and applied products; metals and metal products; machinery and equipment; furniture and household durables; nonmetalic mineral products; transportation equipment; and miscellaneous products. House Report at 601.

[31] House Report at 601.

[32] House Report at 601.

[33] §474(d)(4)(a)(iii).

[34] §474(d)(4)(a)(ii). *See* House Report at 601.

[35] House Report at 602.

[36] House Report at 602.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Comment: Regs. §1.472-8(f)(2) may serve as a model for the conversion of another LIFO method to the simplified dollar value LIFO method for purposes of preserving the pre-existing LIFO layers.

Example: The following example from the House Report shows the computations required by a taxpayer in the first year in which it uses the simplified dollar-value LIFO method. The example assumed that the taxpayer used the FIFO method to calculate inventories in prior years.[37]

The taxpayer's inventory consists of a chemical, classified in the "Chemicals and Allied Products" general category, and a high school chemistry textbook, classified in the "Pulp, Paper and Allied Products" general category. The index numbers for the "Chemicals and Allied Products" general category are 200 for the prior year (the "base year") and 220 for the current year (the "first LIFO year"). The index numbers for the "Pulp, Paper and Allied Products" general category are 142 for the prior year and 150 for the current year. In the prior year, the present dollar value of the taxpayer's ending inventory was $30,000 for the chemical and $30,000 for textbooks. In the current year, the present dollar value of the taxpayer's ending inventory is $35,000 for the chemical and remains at $30,000 for the textbooks.

As the two types of inventory items are classified in different general categories, the taxpayer must set up a separate dollar-value LIFO pool for each. An annual index for each pool is determined by taking one (1) plus the percentage change in the index for the general category. The percentage change for a category is calculated by dividing the difference between the index in the current year and the index in the prior year by the index in the prior year. For the chemical, the percentage change is .1000 ((220 − 200) ÷ 200) and for the textbooks is .0563 ((150 - 142) ÷ 142).

For years after the first year in which the method is used, the annual index would be multiplied by the cumulative index for the prior year to determine the current cumulative index. For the first year in which the simplified dollar-value LIFO method is used, the annual index and the cumulative index are the same.

The present dollar value of the ending inventory for the current year is divided by the cumulative index to restate the ending inventory in its equivalent value in base year dollars. This amount is assigned to the existing LIFO inventory layers at base year cost and multiplied by the cumulative index for the year to which the layer relates in order to find an indexed dollar value for that layer. The excess of current year cost adjusted to base year cost over the base year cost of the beginning inventory (*i.e.*, the ending inventory of the prior year) is the increase in LIFO inventory for the current year which will be valued at the index for the current year. The sum of the indexed dollar values for the layers is the ending LIFO inventory value for the pool.

For the chemical product, the current year dollar value of inventory is divided by the index to determine the dollar value of current year inventory in base year dollars — $35,000 ÷ 1.100 = $31,818. The increase in current year inventory over the base year inventory is $1,818 ($31,818 − $30,000). That amount, which is at base year cost, is then costed at current year cost and added to the existing base year costs to determine the current LIFO inventory value (1,818 × 1.10 = $2,000 + $30,000 = $32,000).

For the textbooks, the current inventory costed at base year costs ($30,000 ÷ 1.0563 = $28,401) is less than base year cost of inventory ($30,000). Accordingly, there has been an invasion of the base year LIFO layer and the ending inventory of the taxpayer for textbooks will be $28,401. The $1,599 of base year cost in inventory which has been sold will be added to cost of goods sold and will reduce the taxable income of the taxpayer.

A taxpayer changing to the simplified dollar-value method from a method that allows inventories to be stated at less than cost (such as the FIFO method) must restore to income any amounts by which the previous inventories were written down below cost, as required by §472(d). The base year dollar value of the pools established for dollar-value computations will include any amounts required to be recognized as income by §472(d).[38]

e. Rules Applicable When Taxpayer No Longer Eligible for Simplified Treatment

A taxpayer using the simplified dollar-value LIFO method is required to change to a different method in the first year that it fails to meet the $5,000,000 average annual gross receipts test. Any change that would have been allowed if made directly from the method used immediately before the adoption of the simplified dollar-value LIFO method to the new method will be allowed at this time. The Conference Committee also anticipated that a taxpayer would always be allowed to return to the method used before the adoption of the simplified dollar-value LIFO method.[39]

Example: If a taxpayer had been using a FIFO method prior to the adoption of the simplified dollar-value method, it would be allowed to change to the same FIFO method it had used previously or any FIFO, LIFO, or other method that it would have been allowed to change to from the FIFO method used immediately prior to the adoption of the simplified dollar-value LIFO method.

In changing from the simplified dollar-value LIFO method to another method, the taxpayer is not required to obtain permission from the Secretary of Treasury for the change if it would not be required to obtain permission if changing directly from the method used immediately prior the adoption of the simplified dollar-value method to the new method. Likewise, the administrative burden of obtaining the change in method should be no greater that it would be if the change were made directly.[40]

[37] House Report at 602-3.

[38] House Report at 602.

[39] H.R. Rep. No. 841, 99th Cong. 2d Sess. II-291 (hereinafter referred to as the "Conf. Rep.").

[40] Conf. Rep. at II-292.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Comment: The Conference Committee comments do not specifically cover those circumstances in which a taxpayer requests permission of the IRS to revoke its election.

Treasury is directed to prescribe regulations for the determination of inventory pools, if the taxpayer continues to use another dollar-value LIFO method, in a year in which an electing taxpayer fails to qualify for the election.[41]

B. Effective Date and Transition Rule

The provision is effective generally for taxable years beginning after December 31, 1986.[42]

Comment: This election may prove beneficial to those taxpayers with gross receipts between $2,000,000 and $5,000,000 which are now limited to increasing the costs of inventory by only 80% of the increase in these indices rather than 100% as allowed by this new provision.[43] It is unclear whether Treasury will amend those regulations which contain the 80% limit on the amount of the increase in the index which the taxpayer may use in computing its individual index and will use the definition of an eligible business under the revised §474 or continue to use the definition in §474(b) before the 1986 TRA.

Amended §474 replaces the pre-1986 TRA law rule allowing taxpayers with average annual gross receipts of $2,000,000 or less to elect to use a single inventory pool in accounting for its inventories using the LIFO method. Any taxpayer who has in effect a valid election to use the single pool method under prior former §474 may continue to account for its inventories using that election, so long as the taxpayer continues to meet its requirements.[44] The House Report indicates that a taxpayer accounting for its inventories using the single pool election of §474 of pre-1986 TRA law is not eligible to elect to use the simplified dollar-value LIFO method of the 1986 TRA for any year in which the election under pre-1986 TRA law is effective. A taxpayer may revoke the election to use the single pool method of §474 of pre-1986 TRA law without the consent of the Secretary of the Treasury.[45]

[41] §474(d)(4).
[42] Act §802(c)(1).
[43] *See* Regs. §1.472-8(e)(3)(ii).
[44] Act §802(c)(2).
[45] House Report at 600.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 22

CASH METHOD LIMITED; ACCRUAL METHOD LIBERALIZED

Charles E. Taylor, Esq.
Silverstein and Mullens
Washington, D.C.

I. New Limitations on Use of Cash Method

A. Introduction

1. Pre-TRA 1986 Law

A taxpayer may generally elect on its first tax return to use any method of accounting that is regularly used in keeping its books if such method clearly reflects its income.[1] There are basically two methods of overall accounting for income tax purposes — the cash method and the accrual method. A method of accounting which reflects consistent application of generally accepted accounting principles in a particular trade or business will clearly reflect income.[2] A taxpayer may use different accounting methods for its books and for tax purposes if it maintains sufficient records which allow reconciliation of the results under the two methods.[3] Once a taxpayer has selected an accounting method, it may only change methods with the permission of the IRS.[4] If a taxpayer's accounting method does not clearly reflect its income, the IRS may specify which accounting method the taxpayer must use.[5]

Taxpayers who use the cash method of accounting generally recognize items of income when actually or constructively received and items of expense when paid.[6] Tax shelters which use the cash method of accounting generally may not recognize items of expense prior to economic performance of the items to which they relate.[7]

Taxpayers using the accrual method of accounting generally accrue items of income when all of the events have occurred that establish the taxpayer's right to receive the income and the amount of income can be determined with reasonable accuracy.[8] Likewise, items of expense are deductible when all events have established an obligation to pay, and the amount of the expense can be determined with reasonable accuracy. Taxpayers using the accrual method of accounting generally may not deduct items of expense prior to the time of economic performance.[9] Taxpayers must keep inventories and use the accrual method of accounting with respect to inventory items if the production, purchase or sale of merchandise is a material income producing factor for the taxpayer.[10] Certain corporations and partnerships with corporate partners that engage in agricultural activities with gross receipts exceeding $1,000,000 are required to use the accrual method of accounting.[11]

2. Reasons for Change

The House Ways and Means Committee indicated that the cash method of accounting frequently does not accurately reflect the economic results of a taxpayer's trade or business during a taxable year.[12] Since the cash method only focuses on when funds are received or disbursed, items of income and expense may be recognized in taxable years other than those in which economic events gave rise to those items. The House Report asserts that the cash method is not in accordance with generally accepted accounting principles. There is also the potential for mismatching of income and deductions, from the Treasury's viewpoint, when the parties to a transaction use differing accounting methods.

The House Ways and Means Committee conceded that the cash method was a simpler accounting method and that its simplicity justified its continued use for some taxpayers. The high cost of compliance with the accrual method was justification for allowing smaller businesses to use the cash method. The complexities required to account for growing crops and livestock under other methods of accounting justified continued use of the cash method in farming businesses other than those already required to use the accrual method. Finally, it was reasoned that individuals, especially those in professional activities, personal services corporations, and pass-through entities (such as partnerships, S corporations and trusts), should be able to use the cash method because they have traditionally used that method.

B. Overview

Under the 1986 TRA, C corporations and partnerships with a C corporation as partner may no longer use the cash method of accounting unless they qualify as farming businesses, qualified personal service corporations and entities

[1] §446(a). Regs. §1.446-1(a)(2). All section references in this Chapter are to the Internal Revenue Code of 1986 and the regulations thereunder unless otherwise specified. All "Act section" references in this Chapter are to sections of the Tax Reform Act of 1986, P.L. No. 99-514, (1986) (hereinafter referred to as the "Act" or "1986 TRA").
[2] Regs. §1.446-1(a)(2).
[3] Regs. §1.446-1(a)(4).
[4] §446(e).
[5] §446(b).
[6] Regs. §1.446-1(c)(1)(i).
[7] §461(i).
[8] Regs. §1.446-1(c)(1)(ii).
[9] §461(h).
[10] §471; Regs. §1.471-1.
[11] §447.
[12] Committee on Ways and Means, *Tax Reform Act of 1985*, H.R. Rep. 99-426, 99th Cong., 1st Sess. 605 (December 7, 1985) (hereinafter referred to as "House Report").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

with average annual gross receipts of $5,000,000 or less for all prior taxable years, and all prior taxable years of any predecessor entity (beginning after December 31, 1985). Tax shelters may not use the cash method of accounting in any circumstance and tax exempt trusts with unrelated business income may not account for those unrelated activities on the cash method.

There are two requirements for an entity to meet the definition of a qualified personal service corporation. The first test ("the function test") requires that all the activities of the corporation are providing services in the fields of health, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts, or consulting. The second test ("the ownership test") requires that employees performing services for the corporation in a field satisfying the function test, retired individuals who performed services for the corporation or its predecessors in such a field, the estate of such an individual, or any person who acquired its ownership interest as a result of a death of such an individual during the 24-month period following the individual's death, must own substantially all (*i.e.*, at least 95%) of the value of the outstanding stock in the corporation. Stock owned by a partnership, an S corporation, or a qualified personal service corporation will be considered as owned by the partners or shareholders. Stock which is held by any plan described in §401(a) that is exempt from tax under §501(a) is treated as held by the employees of the entity.

For the purpose of this section, a tax shelter will have the same definition as in §461(i) of the Code. Such provision includes (1) any enterprise (other than a C corporation) if at any time interests in the enterprise had been offered for sale in any offering required to be registered with a Federal or state agency having the authority to regulate the offering of securities for sale, (2) any syndicate within the meaning of §1256(e)(3)(B), or (3) any tax shelter within the meaning of §6661(b)(2)(C)(ii). For an enterprise engaged in the trade or business of farming, a tax shelter is (1) any tax shelter within the meaning of §6661(b)(2)(C)(ii), or (2) a farming syndicate within the meaning of §464(c).

These provisions are effective for taxable years beginning after December 31, 1986. Taxpayers (including tax shelters) which entered into loans, leases, certain real property contracts, and transactions with related parties prior to September 25, 1985, may continue to report income from those transactions on the cash basis. This revision of the law is a change in a taxpayer's accounting method and requires that the §481 adjustment be taken into account over a four-year period. Net operating losses and tax credit carry forwards will be allowed to reduce any positive §481 adjustment.

An unrelated provision included in this section that allows accrual basis taxpayers to not accrue in income any portion of income based on its experience will not be collected. This provision is effective for taxable years beginning after December 31, 1986.

C. Detailed Analysis

1. General Rule

Under the 1986 TRA, C corporations, partnerships with a C corporation as partner, and tax shelters may no longer use the cash method of accounting unless they are farming businesses, qualified personal service corporations and entities with average annual gross receipts of $5,000,000 or less for all prior taxable years, and all prior taxable years of any predecessor entity (beginning after December 31, 1985) which are not prohibited from using the cash method by other sections of the Code.[13] Section 511(b) tax-exempt trusts also may not use the cash method to account for any activity that constitutes an unrelated trade or business. Taxpayers may not avoid this rule by using a hybrid accounting method which records some, but not all, of the transactions on the cash method.[14] All individuals, sole proprietorships, and S corporations will be able to use the cash method of accounting. Those individuals who are members of partnerships or S corporations with C corporations as partners or shareholders will not be able to use the cash method to account for activities within those entities unless the C corporation partner or shareholder is a qualified personal service corporation, or a qualified farming business, or unless the partnership or corporation has average annual gross receipts of less $5,000,000 for all prior taxable years.

The Conference agreement deleted two provisions of the House bill, H.R. 3838, which allowed (1) a taxpayer, other than a financial institution or a utility, to accrue as income any amount to be received for the performance of services prior to the time the amount was billed, and (2) that economic performance of services provided to an accrual basis taxpayer generally would not have been considered to have occurred prior to the time the taxpayer was billed. The Conference Committee intended that no inference be drawn from its failure to adopt these two provisions as to the economic performance of these items under current law.[15]

2. Tax Shelters

The Conference Committee added the provision to the House Bill which prohibited tax shelters from using the cash method of accounting. For purpose of §448, a tax shelter has the same definition as in §461(i)(3).[16] Such provision includes (1) any enterprise (other than a C corporation) if at any time interests in the enterprise have been offered for sale and such offerings were required to be registered with the federal or state agency having the authority to regulate the offering of securities for sale, (2) any syndicate within the meaning of §1256(e)(3)(B), or (3) any tax shelter within the meaning of §6661(b)(2)(C)(ii). For an enterprise engaged in the trade or business of farming, as defined in §464(e), a tax shelter is (1) any tax shelter within the meaning of §6661(b)(2)(C)(ii), or (2) a farming syndicate within the meaning of §464(c).[17] The general exceptions for farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5,000,000 or less do not apply in the case of tax shelters.[18]

---

[13] §§448(a), (b) and (d)(6).
[14] House Report at 606.
[15] Committee of Conference, *Tax Reform Act of 1986, Conference Report to Accompany H.R. 3838*, H. Rep. No. 841, 99th Cong. 2d Sess. II-288 (hereinafter referred to as the "Conference Report").
[16] §448(d)(3).
[17] Conference Report at II-287. §461(i)(4).
[18] Conference Report at II-287.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

A tax shelter may not take advantage of the recurring item exception under §461(h)(3) to the rule requiring economic performance before an accrual basis tax payment may deduct an item of expense.[19] However, in the case of a tax shelter which is drilling an oil or gas well, economic performance will be considered to have occurred if the drilling of the well commences before the close of the 90th day after the close of the taxable year.[20]

3. Qualified Personal Service Corporations

There are two requirements for an entity to meet the definition of a qualified personal service corporation. The first test, a function test, requires that all the activities of the corporation are providing services in the fields of health, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts, or consulting.[21] The second test, an ownership test, requires that employees performing services for the corporation in a field satisfying the function test, retired individuals who performed services for the corporation or its predecessors in such a field, the estate of such an individual, or any person who acquired its ownership interest as a result of a death of such an individual during the 24 month period after the individual's death, must own substantially all of the value of the outstanding stock in the corporation.[22]

Stock owned by a partnership, an S corporation, or a qualified personal service corporation will be considered as owned by the partners or shareholders of such entity. The Conference Report indicates that substantially all of the stock is defined to mean at least 95% of the value of stock.[23] In applying the ownership test, the applicable community property laws of any state will be disregarded.[24] Stock which is held by any plan described in §401(a) that is exempt from tax under §501(a) is treated as held by the employees of the entity.[25] At the election of the common parent of an affiliated group, all members of such affiliated group may be treated as a single group for the purpose of applying the ownership test if substantially all of the activities of such members involve the performance of services in the same qualified field.[26]

4. Farming Business Exception

Prior to the 1986 TRA, C corporations and partnerships with C corporation partners which engaged in the trade or business of farming were required to use the accrual method of accounting and capitalize preproductive expenditures if their gross receipts exceeded $1,000,000, or more than 50% of all the corporate voting power was retained by one family.[27] Farming businesses, by this definition, are still prohibited from using the cash method of accounting.[28] However, farming businesses in which (1) gross receipts for all preceding taxable years beginning after December 31, 1975 have not exceeded $1,000,000, or (2) at least 50% of the total combined voting power of all classes of stock entitled to vote, and at least 50% of the total number of shares of all other classes of stock are owned by members of the same family,[29] may continue to use the cash method. The House Report provides that a farming business for purposes of this section is any business engaged in the growing, raising, managing or training of crops or livestock. Unlike §447, it also includes the operations of a nursery, or sod farm.[30] For the purpose of determining whether an entity is engaged in a farming business, the definition of farming shall include the raising or harvesting of trees bearing fruit, nuts or other crops, or ornamental trees (including evergreen trees that are not subject to the capitalization provisions of §263A) as well as other timber.[31]

5. Small Business Exception

All taxpayers, other than tax shelters, with average annual gross receipts of $5,000,000 or less during the preceding three taxable years may continue to use the cash method of accounting.[32] Gross receipts are reduced by sales returns and allowances.[33] The calculation is not dependent on gross receipts during the current taxable year, but rather taxpayers must determine the sum of their gross receipts for the preceding three taxable years and divide by three.[34] If there is a partial taxable year in the preceding three years, then the gross receipts for that period are annualized.[35]

> *Example:* A taxpayer commences business on May 1, 1984, and adopts a calendar year as its taxable year. Its gross receipts for its first taxable year are $800,000, for calendar year 1985 — $3,000,000, and for calendar year 1986 — $7,000,000. Receipts for 1984 are annualized by dividing the actual gross receipts for the taxable year, $800,000, by the number of months which the taxpayer conducted business, 8, and multiplying that result by 12. In this case, average monthly gross receipts were $100,000, and annualized receipts for the period were $1,200,000. Average annual gross receipts for determining qualification for the cash method are $3,733,333 ((1,200,000 + 3,000,000 + 7,000,000) / 3). Thus this taxpayer may use the cash method for 1987.

If a taxpayer and its predecessors have operated for less than the three preceeding taxable years, the average is calculated for the number of years which the taxpayer has operated.[36] There is no discussion of a definition of a predecessor corporation or partnership in this context. Presumably these rules may not be avoided by a reorganization of a corporation or liquidation of a partnership with a subsequent formation of a new partnership.

This test contains an aggregation rules for all related entities. If related entities would be treated as a single

[19] New §461(i)(1).
[20] New §461(i)(2).
[21] §448(d)(2)(A).
[22] §448(d)(2)(B).
[23] Conference Report at II-287.
[24] §448(d)(4)(A).
[25] §448(d)(4)(B).
[26] §448(d)(4)(C).
[27] §447.
[28] House Report at 606.
[29] *See* §§447(c) and (e).
[30] New §448(d)(1)(A). *Also see* new §263A(e)(4).
[31] Conference Report at II-288. §448(b)(1)(B).
[32] §448(c)(1).
[33] §448(c)(3)(C).
[34] House Report at 606.
[35] §448(c)(3)(B).
[36] §448(c)(3)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

employer for purposes of subsections (a) or (b) of §52 (including a controlled group of corporations) or subsections (m) or (o) of §414 (including affiliated service groups), then their gross receipts are aggregated for purposes of determining if the entities can use the cash method as a result of the $5,000,000 exemption.[37]

6. Effective Date and Transition Rules

This provision is effective for taxable years beginning after December 31, 1986.[38] Taxpayers may elect to continue to report income from loans, leases, or transactions with related parties (as defined in §267(b) of the Internal Revenue Code of 1954 as in effect before the enactment of the 1986 TRA) entered into before September 25, 1986 on the cash method.[39] Further, contracts for the acquisition or transfer of real property or contracts for services related to the acquisition or development of real property may continue to be accounted for on the cash accounting method if they were entered into prior to September 25, 1985 and payment for the property or services is the sole element of the contract which was not performed as of September 25, 1985.[40] This transition rule applies to tax shelters as well as other entities.[41]

Any change from the cash method mandated by this section is treated as initiated by the taxpayer with consent of the IRS.[42] The §481 adjustment arising from this change in accounting must be taken into income over a period not exceeding four years in accordance with Rev. Proc. 84-74.[43] Net operating losses and tax credit carryforwards may offset any §481 adjustment, and the §481 adjustment will be recognized in taxable income ratably throughout the year to which it applies for estimated tax purposes. The timing for any negative §481 adjustment will be determined as if the adjustment is positive.[44]

Hospitals must take the §481 adjustment into income ratability over no more than a ten-year (instead of a four-year) period.[45] For purposes of this section, a hospital is a taxable or tax-exempt institution that meets all of the following requirements:

(1) It is accredited by the Joint Commission of Accreditation of Hospitals (JCAH), or is accredited or approved by a program of the qualified governmental unit in which such institution is located, if the Secretary of Health and Human Services has found the accreditation or comparable approval standards essentially equivalent to those of JCAH;

(2) It is primarily used to provide, by or under the supervision of physicians, on an inpatient basis, diagnostic services and therapeutic services for medical diagnosis, treatment and care of injured, disabled or sick persons;

(3) It has a requirement that every patient be under the care and supervision of a physician; and

(4) It provides 24 hour nursing services rendered or supervised by a registered professional nurse and has a licensed practical nurse or registered nurse on duty at all times.[46]

The hospital need not be owned by or on behalf of a governmental unit, or by a §501(c)(3) organization, or operated by a §501(c)(3) organization to meet the definition of a hospital so that investor-owned, for-profit hospitals will qualify for this favorable treatment.[47] The Treasury Department may exercise its administrative authority to prevent avoidance of the effective date rules by use of those administrative pronouncements and regulations which allow a taxpayer to change its taxable year without the permission of the IRS.[48]

II. Full Accrual of Income Not Required for Certain Service Providers

A. Introduction

1. Current Law

As discussed above, the accrual method of accounting requires inclusion of amounts in income when all events have occurred which fix the right to receive such income and such amount can be determined with reasonable accuracy.[49] The collectibility of such amounts is only considered under current law in determining the reserve for bad debts in accounts receivables. The 1986 TRA, however, repeals the bad debt reserve method for all taxpayers other than financial institutions.

2. Reasons for Change

The House Ways and Means Committee was concerned that taxpayers may be required to accrue income for

[37] §448(c)(2).
[38] Act §801(d)(1).
[39] Act §801(d)(2).
[40] Act §801(d)(3).
[41] Conference Report at II-288.
[42] §448(d)(7).
[43] 1984-2 C.B. 736. Conference Report at II-289 and §448(d)(7)(C)(i).
[44] Conference Report at II-289.
[45] §448(d)(7)(C)(ii).
[46] House Report at 609.
[47] Conference Report at II-288.
[48] Conference Report at II-207. The IRS recently issued an announcement which restricts the ability of taxpayers to change taxable years. IRS Announcement 86-101, I.R.B. 1986-41, 14. The announcement states that the IRS intends to issue temporary regulations which will restrict the ability of taxpayers to change their taxable years to avoid the impact of the 1986 TRA. Generally the temporary regulations will suspend the provisions of Regs. §§1.441-2(c), 1.442-1(c)(2), 1.706-1(b), and Temp. Regs. §18.1378-1, and any revenue procedure issued before September 18, 1986 that permits a taxpayer to change its taxable year (including a 52-53 week taxable year) without the consent of the IRS or under a procedure for securing expedited approval. As noted above, the IRS will only approve changes in according periods for substantial business purposes established under a mechanical test.

Approval may be granted in cases in which the taxpayer has had a substantial acquisition or divestiture in the preceding twelve months which would justify a change in accounting period. Special rules will also apply to taxpayers who wish to change their 52-53 week taxable year with reference to the same month of the year as that in the preceding taxable year. If a taxpayer meets one of the tests specified in the temporary regulations, it may change its taxable year without the permission of the IRS. The temporary regulations will generally apply to any change in annual accounting period if the income tax return for the short period involved in the change is filed after September 29, 1986. The temporary regulations will not, however, apply to cases where the due date for the short period (without regard to any extensions) is before September 29, 1986 and the income tax return is timely filed (with regard to extensions). The temporary regulations will not apply to a request to change to a calendar taxable year. Taxpayers who have short periods for which a tax return is due after September 29, 1986, but have timely filed a request with the IRS to use a non-calendar taxable year prior to September 30, 1986, are specifically exempted from the ambit of this announcement.
[49] Regs. §1.446-1(c)(1)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

services on amounts they are unlikely to collect (*see* House Report at 605-606). If a taxpayer includes accounts receivable in income when they bear no interest or late charge, income is overstated if that account is subsequently not collected. The present value of the deduction for the bad debt is less than the present value of the amount of income currently taxable. If an account bears interest or a late charge, the Ways and Means Committee did not allow exclusion of a portion of the account receivable because the present value of an obligation bearing interest is the same as the present value of the income accrued.

Comment: The explanation for this exception defies logic. The fact that an uncollectible amount accrues interest or a late charge, which realistically will also never be paid, does not make the present value of the income accrued equal the present value of the bad debt eventually deducted unless the taxpayer is not required to include the unpaid interest or late charge in income during the period over which they accrue. The 1986 TRA does not indicate that this nonaccrual of interest or late charges on uncollected accounts receivable is permitted.

B. Overview

An accrual basis taxpayer is not required to accrue as income any portion of amount billed for the performance of services which, on the basis of its own experience it will not collect. The rule does not apply if the taxpayer charges any interest or penalty for failure to make timely payment in connection with the amount billed. To the extent that collections of accounts receivable at the end of a taxable year exceed the amount included in income for those receivables, the taxpayer must recognize that amount in income. If a receivable is determined to be partially or wholly uncollectible and uncollectible receivables arising in the same year equal or exceed the amount of revenues not accrued that year, then a deduction will be allowed for that amount.

C. Detailed Analysis

1. General Rule

TRA 1986 adds new §448(d)(5) to the Code which allows any person using the accrual method of accounting who performs services to exclude from income a portion of its income from performing such services based on its experience will not be collected if it does not require its customers to pay interest on, or penalty for failure to timely pay, such amount.[50] The provision applies to taxpayers already on the accrual method and those forced to use the accrual method because of the Act.[51] The statute does not include a definition of the performance of services. The House Ways and Means Committee indicated that it does not include the activities of banks and other financial institutions.[52] One reasonable definition of services is in §448 defining personal service corporations. Services in the areas of health, law, engineering, architecture, actuarial science, performing arts or consulting by this definition should qualify for this special treatment.

If a taxpayer charges any interest or penalty for failure to make timely payment in connection with an amount billed, such sales will not qualify for less than full accrual of the amount of the sale. However, the offering of a discount for early payment of an amount billed will not prevent application of the rule as long as the full amount of the bill is otherwise accrued as income and the discount for early payment is treated as an adjustment to income in the year such payment is made.[53]

Comment: It is not clear how many accrual basis taxpayers who provide services do not impose some finance charge for delayed payment of billings. Also, there is nothing in the statute or legislative history which would prevent, for example, a department store from determining which portion of its year end accounts receivables are from services (*e.g.*, dry cleaning, shoe repair, hair styling) and excluding an estimate of the uncollectible portion of those receivables from income. Mechanically performing this task may make it uneconomical for the tax savings.

The House Ways and Means Report prescribes the method for determining the amount of income which is uncollectible. The taxpayer must determine the total amount billed (presumably for services and not for other products of the taxpayer) which are uncollected at the end of the taxable year and multiply that number by a fraction the numerator of which is the total amount of such receivables which were billed and determined not to be collectible within the most recent five taxable years of the taxpayer, and the denominator of which is the total of such amounts billed within the same five year period. If the taxpayer has not been in existence for the prior five taxable years, the portion of the five year period in which taxpayer has existed will be used.

Comment: The formula which the House Report specifies in its text overstates the amount of income which should be excluded in any taxable year. The fraction which is determined above should theoretically be multiplied by the amount of receivables from services rendered during the year which remain unpaid at the end of the taxable year instead by the amount of all services rendered during the taxable year. A large portion of the receivables billed during a year should have been collected by the end of the taxable year and there is no doubt as to whether they will be collected. The example provided in the House Report correctly calculates the amount of income which should be excluded.

For example, an accrual basis taxpayer has $100,000 of receivables that have been created during the most recent five taxable years. Of that $100,000 of receivables, only $1,000 has been determined to be uncollectible. Based on the taxpayer's experience, the amount of receivables outstanding at the end of the taxable year which is not expected to be collected is 1% ($1,000/$100,000).[54] There does not seem to be any reason to annualize these results for any short taxable period during the preceding five years.

As a result of this election, a taxpayer must keep accurate records of receivables from customers and the year to which payments are applied. At such time as the amounts received for receivables outstanding at the end of a

[50] §448(d)(5).
[51] *See* Conference Report at II-288.
[52] House Report at 608 (note 3).
[53] House Report at 608.
[54] *Id.*

taxable year exceed the amounts included in income for those receivables, that excess must be included in income in the year of receipt.[55] To the extent that amounts outstanding at the end of a taxable year are determined to be uncollectible, there is no deduction for those amounts except to the extent that they exceed the amount of income which was not recognized in such year.[56]

The House Ways and Means Committee also indicated that the Treasury Department should provide a periodic system of accounting for billings which will not be collected where that system results in the same taxable income as would be the case if each receivable were recorded individually.[57] Apparently this provision means that the computation of the percentage of uncollectible receivables may be made on a periodic determination of receivables rather than by the individual receivables.

[55] *Id.*
[56] *Id.*
[57] *Id.*

2. Effective Date

This provision is effective for taxable years beginning after December 31, 1986.[58] A change to this method shall be treated as made at the initiative of the taxpayer with the consent of the Commissioner. It appears that the provision is elective, but there is no statement of how an election is to be made or revoked. A taxpayer is not required to exclude the full amount which is uncollectible based on prior experience and it is not clear if he could consistently exclude a percentage of the amount which is calculated to be uncollectible instead of the full amount. It also does not appear that there should be a restatement of the amount of receivables outstanding at the beginning of the first taxable year for which this provision is effective which would require a §481 adjustment. Receivables of prior years which are determined to be uncollectible in a taxable year after the effective date of this provision should still qualify for charge-off as a bad debt.

[58] Act §801(d)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 23

RESTRICTIONS ON ADOPTION OF A FISCAL YEAR BY PASS-THROUGH ENTITIES AND PERSONAL SERVICE CORPORATIONS

Charles E. Taylor, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. Pre-1986 TRA

1. General Rules

Taxable income is computed on the basis of a taxpayer's taxable year.[1] A taxpayer's taxable year generally is required to be the same as the taxpayer's annual accounting period, *i.e.*, the 12-month period on the basis of which the taxpayer regularly computes his income in keeping his books.[2] A taxable year that ends on the same day of the week in each year (a 52-53 week year) is also acceptable.[3] Taxpayers generally are allowed to select any taxable year on their first Federal income tax return that is consistent with their annual accounting period. The taxable year for most individuals is the calendar year. Certain types of entities, including partnerships and S corporations, are required to select taxable years that generally conform to taxable years of their owners. Once a taxable year is selected, the permission of the IRS is required for any change.[4]

2. Partnerships

Under current law, partners in a partnership take into account their allocable share of income, gain, loss, deduction or credit of the partnership for their taxable year in which the partnership's taxable year ends.[5] Such items of income, gain, loss, deduction, or credit are computed at the partnership level and reflect the partnership's (not the partner's) taxable year.[6] To the extent that the partner's and the partnership's taxable years are not the same, a deferral of income can result.

Example: Assume a partnership has a taxable year ending in June, while an individual partner has a calendar taxable year. The partner will include in his income tax return for the current calendar taxable year his distributive share of partnership items that arose in the first six months of the current calendar year and his share of such items that arose in the last six months of the prior calendar year. Partnership items arising in the last six months of the current calendar year will not be included in the partner's return until the following calendar year. Thus, the recognition of six months' of partnership income and expenses has been deferred by the partner until the following taxable year.

Current law requires a partnership adopting or changing a taxable year to use the taxable year of all of its principal partners (or the calendar year, if all of the partnership's principal partners do not have the same taxable year), unless the partnership establishes to the satisfaction of the IRS a business purpose for selecting a different taxable year.[7] A partnership that adopted its taxable year prior to April 2, 1954, is not required to change its taxable year regardless of whether or not the taxable year adopted is the same as the taxable year of all of its principal partners.[8]

In 1972, the IRS issued Rev. Proc. 72-51 [9] announcing the procedures it would follow in approving a request by a partnership desiring to change to, or adopt, a taxable year other than that of all of its principal partners. The Rev. Proc. provided that consideration would be given to all the facts and circumstances, including any distortion of income due to the deferral of income, in determining whether a taxable year different from that of all the principal partners is acceptable. However, in order to facilitate adoptions or changes with a minimum of distortion, a request by a partnership to adopt or change to an accounting period differing from that of its principal partners would generally be approved where the adoption of such change would result in the deferral of income to the partners of three months or less. Under Rev. Proc. 72-51, if a taxpayer adopted a taxable year providing three months or less deferral of income, the taxpayer was required to add a certain amount of income to the short period required to effect the adoption or change of taxable year (*i.e.*, the "§481 adjustment"). The taxpayer was then allowed to deduct this amount ratably over a 10-year period beginning with the year of change.

---

[1] §441(a). All references in this chapter to Code sections are to the Internal Revenue Code of 1986, and the regulations thereunder, and references to the "prior Code" are to the Internal Revenue Code of 1954 prior to passage of the Act.
[2] §441(b) and (c).
[3] §441(f)(1).
[4] §442.
[5] §706(a).
[6] §706(b)(1).
[7] *Id.* Regs. §1.706-1(b)(1). A principal partner is a partner having an interest of 5% or more in partnership profits or capital. §706(b)(3).
[8] Regs. §1.706-1(b)(6).
[9] 1972-2 C.B. 832.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

3. S Corporations

Under current law, shareholders of an S corporation take into account undistributed taxable income and net operating losses of the S corporation for their taxable year in which the S corporation's taxable year ends.[10] To the extent that the taxable year of a shareholder and an S corporation are not the same, a deferral of tax can result that is similar to the deferral with respect to partnerships, as discussed above.

Current law requires a corporation that makes an election to be taxed as an S corporation, or an S corporation that changes its taxable year, to adopt a "permitted year." [11] A permitted year is a calendar year or any other accounting period for which the S corporation establishes a business purpose to the satisfaction of the Secretary.[12] A corporation that was an S corporation for a taxable year that includes December 31, 1982 (or that was an S corporation for a taxable year beginning in 1983 by reason of an election made on or before October 19, 1982) may retain a taxable year that is not a permitted year.[13] However, if more than 50% of the stock of such an S corporation is newly owned stock, the S corporation must change its taxable year to a permitted year. Rev. Proc. 83-25 [14] provides procedures similar to those in Rev. Proc. 72-51, above, that the IRS will follow in approving a request by an S corporation to change to, or adopt, a taxable year other than a calendar year. Rev. Proc. 83-25 provides that requests will be approved where the adoption of the taxable year results in the deferral of income to shareholders of three months or less.

4. Personal Service Corporations

Under present law, personal service corporations generally are taxed in the same manner as other C corporations. A personal service corporation generally may adopt any taxable year on its first Federal income tax return that conforms with its annual accounting period.[15] A personal service corporation desiring to change its taxable year must first obtain the consent of the IRS.[16]

A personal service corporation normally reports its income and pays tax only at the corporate level. However, a deferral even greater than the deferrals available for partnerships and S corporations may be accomplished through the use of the personal service corporation.

Example: Assume a personal service corporation with a taxable year ending in January pays its calendar year employee-owners a minimal salary during the year and, immediately prior to the close of the corporation's taxable year (*i.e.*, sometime during January), declares a bonus to the employee-owners equal to the profits of the the corporation. The corporation obtains a deduction for the bonus paid in the year ending in January and the employee-owners need not report the bonus income until the following December, when the employee-owners' calendar taxable years end. Thus, the tax on the bonus is effectively deferred.

Current law provides special rules for a personal service corporation substantially all the services of which are performed for or on behalf of one other entity, and which is formed or availed of primarily to avoid or evade tax. The IRS is empowered to allocate all income, deductions, credits, exclusions, and other allowances between this type of personal service corporation and its employee-owners, if such allocation is necessary to prevent the avoidance or evasion of Federal income tax or to clearly reflect the income of the personal service corporation or any of its employee-owners.[17] This rule does not apply in the case where the personal services of the corporation are performed on behalf of more than one other entity, such as a professional corporation with more than one employee-owner.

B. Reasons for Change

The Senate Finance Committee believed that pre-1986 TRA law allowed an improper deferral of income for certain partners, shareholders in S corporations, and owners of personal service corporations. Older partnerships, partnerships where the taxable year of the principal partners is not representative of the taxable year of the majority partners, older S corporations, and personal service corporations, are allowed taxable years that make such deferral of income possible, while other partnerships and S corporations are required to use taxable years conforming more closely to the taxable years of their owners. The committee believed that this feature of pre-1986 TRA law decreased the fairness of the Code and provided an unwarranted competitive advantage to certain taxpayers.[18]

II. Overview

Under the Tax Reform Act of 1986 ("1986 TRA"), partnerships must adopt the same taxable year as the partners owning a majority interest in the partnership profits and capital. §706(b)(1)(B). If a majority of such partners do not have the same taxable year, the partnership is required to adopt the same taxable year as all of its principal partners. If all of the principal partners do not have the same taxable year, the partnership is required to adopt a calendar year. A partnership may establish to the satisfaction of the Service a business purpose for having a different taxable year. §706(b)(1)(C). S corporations and personal service corporations are required to adopt a calendar taxable year unless they have established to the satisfaction of the IRS a business purpose for having a different taxable year.

The Conference Report (at II-319) indicates that the reasons for approving a business purpose exception will be very stringent. If 25% or more of a taxpayer's gross receipts for a 12-month period are recognized in the last two months of the period (as in Rev. Proc. 83-25), the taxpayer will

[10] §1366(a)(1).
[11] §1378(a).
[12] §1378(b).
[13] *See* §1378(c)(1).
[14] 1983-1 C.B. 689.
[15] §441(b).
[16] §442.
[17] §269A(a).
[18] Senate Finance Committee, S. Rep. No. 313, 99th Cong., 2d Sess. 165 (hereinafter referred to as "S. Rep.").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

qualify for the business purpose exception. Partnerships and S corporations which have obtained a business purpose exception (not just the three month deferral exception) for a taxable year not coinciding with their owners' after Rev. Proc. 74-33 became effective may continue to use their existing taxable years.

The Treasury should issue regulations which require that a taxpayer using a 52-53 week taxable year must include the items of income in the taxable year ending on the last day of the calendar month nearest to the close of its taxable year. Conference Report at II-319.

An unrelated change included in this section (Act §806(c)) now defines an employee-owner and his personal service corporation as related parties for purposes of §267. Thus, a personal service corporation may not deduct payments to an employee-owner prior to the time that person would include the payment in his gross income.

III. Detailed Analysis

A. General Rule

The 1986 TRA requires generally that all partnerships, S corporations, and personal service corporations conform their taxable years to the taxable years of their owners.[19] The Act provides that a partnership may not have a taxable year other than the taxable year of its partners owning a majority (greater than 50%) interest in partnership profits and capital, unless it establishes to the satisfaction of the IRS a business purpose therefor.[20] If partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership must adopt the same taxable year as all its principal partners.[21] If the principal partners of the partnership do not have the same taxable year, the partnership must adopt a calendar year as its taxable year or the taxable year which the Treasury prescribes in regulations.[22]

Example: Assume a partnership has one principal partner which is a fiscal year corporation owning a 10% interest in partnership profits and capital. The remainder of the partners are individuals on a calendar taxable year; none of these individuals owns a sufficient interest in the partnership to be a principal partner. Under pre-1986 TRA law, the partnership would be required to adopt the same taxable year as the corporate partner (*i.e.*, the taxable year of its principal partner). However, under the 1986 TRA, the partnership would be required to adopt a calendar taxable year (*i.e.*, the taxable year of the majority of its partners).

In determining if the taxable year of the partnership will be the taxable year of the majority in interest of the partners, that alternative will only apply if partners who have an aggregate interest in partnership profits and capital of 50% or more have had the same taxable year in the three taxable years immediately preceding the beginning of such year for determination of the partnership's taxable year. If the partnership has not been in existence during all of the preceding three taxable years, consideration is given to the taxable years of such partners ending with or within the partnership's period of existence.[23] This rule applies so that the *same* partners are not required during the three-year period preceding the election to have had the taxable year which the partnership is to elect.

Example: A partnership has three equal partners. As of the end of 1986, the partnership has a calendar taxable year, two partners have a taxable year ending in June, and the third has a taxable year ending in December. However, two of the partners changed their taxable years in 1985 — one from June to December and the other from December to June. The partnership is now required to have a taxable year ending in June even though two of the partners changed their taxable years during the three year period preceding the year of determination of the partnership taxable year. During all three preceding periods, two-thirds of the partners had taxable years ending in June, even though they are not the same partners.

Comment: This provision will require partnerships to closely monitor the taxable years of their new partners and to require that existing partners inform them when they change their taxable year.

All S corporations must now adopt a permitted year as their tax accounting period, regardless of when the corporation elected to be taxed as an S corporation. §1378(a). The bill also requires that all personal service corporations must now adopt a calendar taxable year. §441(i)(1).

B. Business Purpose Exception

An exception is provided in each case where the partnership, S corporation, or personal service corporation establishes, to the satisfaction of the IRS, a business purpose for having a different taxable year. Unlike the Senate Report, the final bill provided that the deferral of income to owners for a limited period of time, such as the three months or less rule of pre-1986 TRA law, is not to be treated as a business purpose.[24]

A partnership, S corporation, or personal service corporation seeking to use a taxable year other than the taxable year required by this provision must obtain the consent of the IRS. The Senate Finance Committee expected that the concepts embodied in the current revenue procedures dealing with the taxable years of partnerships and S corporations [25] would be followed to the extent they did not conflict with the new law. Partnerships and S corporations having previously established to the satisfaction of the IRS in accordance with the terms of those revenue procedures, a sufficient business purpose for using a different taxable year (other than a year-end that resulted in a three month

[19] Act §806(a) amending §706(b)(1) and (4) (partnerships); Act §806(b) amending §§1378(a) and (b) (S corporations); and Act §806(c) adding §441(i) (personal service corporations).

[20] §706(b)(1)(B)(i).

[21] §706(b)(1)(B)(ii).

[22] §706(b)(1)(B)(iii).

[23] §706(b)(4).

[24] §706(b)(1)(C); §1378(b); and §441(i)(1); Conference Report to Accompany H.R. 3838, H.R. Rep. No. 841, 99th Cong., 2d Sess. II-318 (hereinafter referred to as the "Conference Report").

[25] Rev. Proc. 72-51, 1972-2 C.B. 832, and Rev. Proc. 83-25, 1983-1 C.B. 689.

or less deferral of income) will not be required to obtain the IRS's permission in order to keep such taxable year.[26]

Moreover, any partnership, S corporation, or personal service corporation may adopt, retain, or change to a taxable year, under procedures established by the IRS, if the use of such year meets the requirements of the "25% test" as described in Rev. Proc. 83-25.[27] In addition, the IRS may prescribe other tests to be used to establish the existence of a business purpose, if, in the discretion of the IRS, such tests are desirable and expedient towards the efficient administration of the tax laws.[28]

The Conference Committee intended that: (1) the use of particular year for regulatory or financial accounting purposes; (2) the hiring patterns of a particular business, *e.g.*, the fact that a firm typically hires staff during certain times of the year; (3) the use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders; and (4) the fact that a particular business involves the use of price lists, model year, or other items that change on an annual basis ordinarily will not be sufficient to establish that the business purpose requirement for a particular taxable year has been met.[29]

C. Definition of Personal Service Corporation

For purposes of this provision, a personal service corporation is generally the same as under §269A(b)(1) — a corporation the principal activity of which is the performance of personal services if services are substantially performed by employee-owners.[30] An employee-owner is any employee of the corporation who owns, on any day during the taxable year, any of the outstanding stock of the corporation.[31] In determining whether an employee owns stock in the corporation, the constructive ownership rules of §318 apply, except that the attribution of stock owned by a corporation to the employee is applied without regard to any requirement that the employee own a certain percentage of the value of the stock of that corporation.[32] For purposes of this provision, a corporation that has elected S corporation status will not be considered a personal service corporation.[33]

Comment: There are no regulations under §269A which define "substantial performance" by owner-employees. Some taxpayers have taken the position that, if there are a large number of non-owner employees, the services of an owner-employee may be insubstantial when compared with the services of non-owner-employees. Tax Management understands that the staff of the Joint Committee on Taxation are aware of this problem and are likely to recommend that the "substantial performance" terminology be replaced with a "material participation" requirement. In that manner, the participation by an owner-employee will subject the personal service corporation to the calendar year requirement.

D. Amendment of 52-53 Week Taxable Year Rules

The Conference Committee anticipated that Treasury would promulgate regulations regarding the use of the 52-53 week taxable year to prevent the evasion of the principles of the Act.[34] The regulations would provide that, for purposes of determining when taxable income is included by a partner or S corporation shareholder, a 52-53 week taxable year of a partner, shareholder, partnership, or S corporation would be treated as ending on the last day of the calendar month ending nearest to the last day of such 52-53 week taxable year.[35]

> *Example*: A calendar year partner will include its share of taxable income from a partnership with a 52-53 week taxable year ending on January 3, 1988 in its 1987 calendar year Federal income tax return.

The IRS may also prescribe similar rules to prevent the evasion of the principles of the fiscal year restrictions through the use of a 52-53 week taxable year by personal service corporations and the shareholder-employees of such corporations. The IRS will suspend the operation of Regs. §1.441-2(c) allowing taxpayers in certain cases to adopt, or change to, a 52-53 week taxable year without the approval of the IRS.[36]

E. Related Party Rules for Personal Service Corporations

The Conference Agreement extended the provisions of §267 to provide that a personal service corporation and its employee-owners are treated as related taxpayers regardless of the amount of the corporation's stock owned, directly or indirectly, by the employee-owner.[37] Thus, a personal service corporation may not deduct payments made to employee-owners prior to the time that such employee-owner would include the payment in gross income.[38]

F. Effective Date

These amendments are effective for taxable years beginning after December 31, 1986.[39] Entities required to change their taxable years as a result of these amendments will be required to file a return for the short taxable year that begins with the first day of their current taxable year beginning after December 31, 1986, and ends in accordance with the taxable year to which the entity must change.

---

[26] S. Rep. at 167; Conf. Rep. at II-319.

[27] 1983-1 C.B. 689 (*i.e.*, 25% or more of the taxpayer's gross receipts for the 12-month period in question are recognized in the last two months of such period and this requirement has been met for the specified three consecutive 12-month periods). Conf. Rep. at II-319. *See* Announcement 86-101, 1986-41 I.R.B. 14, which indicates that the IRS will only allow substantial business purpose exemptions for non-calendar taxable years when the taxpayer meets certain mechanical tests to be set forth in temporary regulations.

[28] Conf. Rep. at II-319.

[29] *Id.*

[30] §441(i)(2).

[31] §441(i)(2)(A).

[32] §441(i)(2)(B).

[33] S. Rep. at 167.

[34] §441(f)(3). Act §806(d).

[35] Conf. Rep. at II-319.

[36] Conf. Rep. at II-319-20. *See* Announcement 86-101, 1986-41 I.R.B 14, which announces the Treasury's intention to suspend the application of Regs. §1.442-1(c)(2) to any change in accounting period if the income tax return for the short period is filed after September 29, 1986. These temporary regulations will not apply to any change in which the short period return is due prior to September 29, 1986, without regard to extensions, but is timely filed with regard to extensions.

[37] §267(a). Act §806(c)(2).

[38] Conf. Rep. at II-318.

[39] Act §806(e)(1).

Comment: It may be advantageous for a partnership or S corporation which must change its taxable year to accelerate 1988 income into a short period in 1987. While it will pay income tax on one quarter of the income at a time earlier than it would have had it not accelerated recognition and at a higher income tax rate, it will defer payment of the income tax on one-half of the income until its taxable years in 1989 and 1990. Whether this will be advantageous to a taxpayer will depend on the return it can earn on deferred payments. If the differential is insufficient to justify acceleration, cash basis taxpayers may consider deferral of billing for services rendered until after the short period to reduce the income bunching occurring upon change of the taxable year. This may also reduce the amount of tax due because of the reduction in rates.

The IRS recently issued two announcements which restrict the ability of taxpayers to change or adopt new taxable years.[40] The first announcement states that the IRS intends to issue temporary regulations which will restrict the ability of taxpayers to change their taxable years to avoid the impact of the 1986 TRA. Generally, the temporary regulations will suspend the provisions of Regs. §§1.441-2(c), 1.442-1(c)(2), and 1.706-1(b), and Temp. Regs. §18.1378-1T, and any revenue procedure issued before September 18, 1986 that permits a taxpayer to change its taxable year (including a 52-53 taxable year) either without the consent of the Commissioner or under a procedure for securing expedited approval. As noted above, the IRS will only approve a substantial business purposes for non-calendar taxable years if the taxpayer meets a mechanical test.

Approval may be granted in cases in which the taxpayer has had a substantial acquisition or divestiture in the preceding 12 months which would justify a change in accounting period. Special rules will also apply to taxpayers that wish to change their 52-53 week taxable year with reference to the same month of the year as that in the preceding taxable year. If a taxpayer meets one of the tests specified in the temporary regulations, it may change its taxable year without the permission of the IRS. The temporary regulations will generally apply to any change in annual accounting period if the income tax return for the short period involved in the change is filed after September 29, 1986. The temporary regulations will not, however, apply to cases where the due date for the short period (without regard to extensions) is before September 29, 1986, and the income tax return is timely filed (determined with regard to extensions). The temporary regulations will not apply to a request to change to a calendar year. Taxpayers that have short periods for which a tax return is due after September 29, 1986, but have timely filed a request with the IRS to use a non-calendar taxable year prior to September 30, 1986 are specifically exempted from the ambit of this announcement.

The second IRS announcement suspends those provisions of Rev. Procs. 72-51 and 83-25 which allow partnerships and S corporations to request approval of the adoption of taxable years which result in three months or less deferral of income to owners of those entities. Temporary regulations will require that taxpayers establish a substantial business purpose for adoption or retention of a non-calendar taxable year. This requirement will not, however, apply to sections of those revenue procedures which are not suspended by the temporary regulations (*e.g.*, §4.02 of Rev. Proc. 83-25).

This suspension applies to requests for determination of taxable year which was not filed prior to November 6, 1986. The temporary regulations do not apply to adoption of a partnership year that begins before January 1, 1986.

The Act provides that a partnership, S corporation, or personal service corporation that changes to a taxable year required by the amendment will be treated as having made the change with the consent of the IRS and will not be required to file for permission to make the change on Form 1128.[41] In the case of a partnership or S corporation, each partner or shareholder may elect to take the excess of income over expense for any short taxable year that results from the change in the taxable year into account ratably over the first four taxable years (including the owner's year which would otherwise include the income or loss of the entity's short taxable year) beginning after December 31, 1986.[42] Absent such an election, the amount of net income or loss for the short taxable year is currently included, in its entirety, by the owner.[43] The rule is applicable regardless of what type of entity the partner or S corporation shareholder is.[44]

Example: A personal service corporation that is a partner in a partnership required to adopt a new taxable year as a result of this provision is eligible to include the partner's distributive share of partnership income over four taxable years.

The Senate Finance Committee indicated that, in the case of a personal service corporation, the short taxable year resulting from the change of taxable year will be annualized under §443(b) and will not report solely the income earned during its short period.[45] A personal service corporation is not allowed a four-year spread for income earned during the short taxable year. Thus, shareholders of personal service corporations may be left with the harsh result of having two years of income included on one individual tax return.

As noted in the introduction, some partnerships and S corporations that adopted a taxable year other than a calendar taxable year which provided a deferral of income to owners of three months or less were required to include the amount of deferred income over a 10-year period.[46] The Conference Report indicates that any portion of such amount not taken into income as of the effective date of the amendment may be used to reduce the income attributable to any short taxable year resulting from the amendment.[47]

[40] Announcement 86-101, 1986-41 I.R.B. 14 and Announcement 86-113, 1986-47 I.R.B. 46.

[41] Act §806(e)(2)(B).

[42] Act §806(e)(2)(C). This provision applies to a shareholder of an S corporation only if such corporation was an S corporation for a taxable year beginning in 1986.

[43] S. Rep. at 167.

[44] Conf. Rep. at II-318.

[45] S. Rep. at 167.

[46] *See* Rev. Proc. 72-51, 1972-2 C.B. 832.

[47] Conf. Rep. at II-320.

Chapter 24

MISCELLANEOUS ACCOUNTING METHOD AMENDMENTS

Charles E. Taylor, Esq.
Silverstein and Mullens
Washington, D.C.

I. New Income Accrual Requirements for Utilities

A. Introduction

1. Background

Under the accrual method of accounting, utilities, as well as all other taxpayers, must recognize income at the time when all the events have occurred which establish the utilities' right to receive the income and the amount of income can be established with reasonable accuracy. In Rev. Rul. 72-114,[1] the IRS allowed utilities to use a variation of the accrual method which recognizes income based upon the taxable year in which a customer's utility meter is read regardless of when it is billed (the "cycle meter reading" method) if that method is used for financial statement purposes. Under the cycle meter reading method, if the meter reading date falls within the current taxable year, the income attributable to utility service provided on or before the reading date is included in gross income in that taxable year. Any utility services provided to customers within the current taxable year after the last meter reading date of the year will be recognized as income in the following taxable year. A Tax Court case[2] expanded the use of the cycle meter reading method beyond that allowed in Rev. Rul. 72-114 by allowing utilities that do not use the cycle meter reading method for financial statement purposes to use it for federal income tax purposes.

2. Reasons for Change

The Senate Finance Committee believed that the cycle meter reading method of accounting incorrectly measured the taxable income of utilities because it did not provide for recognition of income as it was earned and because it might result in the mismatching of income and expense. Likewise, the Finance Committee believed that utilities which did not use meters should be required to recognize income as it was earned and not at some later time when it was billed, or might be billed, by the utility.[3]

B. Overview

The 1986 TRA[4] requires utilities to recognize income from providing their services to their customers in the year in which such services are provided and not in the year in which a meter is read or the time at which a customer is or may be billed. This will require a utility to estimate usage of services after the final meter reading or billing date which falls within the utility's taxable year. Utilities specifically covered are those providing electrical energy, water or sewage disposal, local gas or steam distribution, telephone and other communication services, and transportation of gas or steam by pipeline.

To reduce conflicts between the IRS and taxpayers, the 1986 TRA further provides that a method of accounting which took into account income from providing utility services to customers on the basis in which the customers' meters were read is a proper method of accounting for any taxable year beginning before August 16, 1986.

C. Detailed Analysis

1. General Rule

The 1986 TRA requires a utility to recognize income from providing services to its customers in the year in which such services are provided and not in the year in which a meter is read or the time at which a customer is or may be billed.[5] Services will be considered to be provided at the time the services are made available to the customer and used by him. For example, water is considered provided at the time the customer withdraws it from a utility's system.[6] This will require a utility to estimate usage of services after the final meter reading or billing date which falls within the utility's taxable year.[7] Where actual determination of the usage of services after the final meter reading or billing date is impracticable, an estimate may be made by assigning a pro rata portion of revenues determined as of the first meter reading date or billing date of the following taxable year.[8]

Utilities specifically covered by this provision are those providing electrical energy, water, sewage disposal, local gas or steam distribution, telephone or other communication services, and transportation of gas or steam by pipeline.[9] There is no requirement that the utility be regulated by a government or governmental agency for it to meet the definition of a utility.[10] It is anticipated that utility services which might come into existence at some future date will also be subject to these rules.[11]

The Finance Committee intended that this new provision will create no inference as to the proper recognition of

---

[1] 1972-1 C.B. 124 clarifying Rev. Rul. 65-287, 1965-2 C.B. 150.
[2] *Orange and Rockland Utilities v. Comr.*, 86 T.C. 199 (1986)
[3] S. Rep. No. 313, 99th Cong., 2d. Sess. p. 120 (1986) (hereinafter referred to as the "Sen. Rep.").
[4] Act §821 (P.L. 99-514, 100 Stat. _____ (1986)). All code section references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder, unless otherwise indicated.
[5] §451(f)(1).
[6] Sen. Rep. at 121.
[7] *See* §451(f)(2)(B); Sen. Rep. at 121.
[8] Sen. Rep. at 121.
[9] §451(f)(2)(A).
[10] Sen. Rep. at 121.
[11] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

income by utilities before its enactment.[12] However, to reduce conflicts between the IRS and taxpayers, the 1986 TRA provides that, a method of accounting which took into account income from providing utility services to customers on the basis in which the customers' meters were read, is a proper method of accounting for any taxable year beginning before August 16, 1986.[13] This relief provision does not extend to any other method of reporting income by utilities such as a method which includes items in income on the date they are billed to a customer.[14]

2. Effective Date and Transition Rules

This provision is effective generally for taxable years beginning after December 31, 1986.[15] If a taxpayer is required to change its method of accounting for any taxable year as a result of this provision, the change will be treated as initiated by the taxpayer and made with the consent of the Secretary. The net §481 adjustment made as a result of this change for both income and expense should be taken into income ratably over the first four years for which the proposal is effective.[16] Net operating losses and tax credit carryforwards will be allowed to reduce any positive §481 adjustment. For estimated tax purposes, the §481 adjustment will be recognized as occurring ratably throughout the year to which the adjustment is allocated.[17]

The Conference Committee intended that utilities required to accrue income at the time utility services are furnished to customers may, at such time, accrue any deductions for the related costs of providing the utility services if economic performance has occurred with respect to those costs within that taxable year. The conferees further intended that any accounting method change required under this provision include any related change in accounting method for the related items of expense or deduction. The §481 adjustment is then to be determined on the net amount of the two changes and taken into account ratably over a four-year period.[18]

Comment: Since Rev. Rul. 72-114 [19] allowed utilities to deduct expenses relating to services sold after the final meter reading and before the end of the taxable year from income in the year sold, many utilities will have only an adjustment to income and no adjustment to related expenses.

II. Contributions in Aid of Utilities' Construction Included in Income of the Utility

A. Introduction

1. Pre-1986 TRA Law

Under pre-1986 TRA law, the income of a corporation does not include any contribution to its capital.[20] A corporation that is a regulated public utility which provides electric energy, gas (either through a local distribution system or through a pipeline), water, or sewage disposal services may treat contributions in aid of construction as non-taxable contributions to capital.[21] Any moneys received as contributions in aid of construction must be spent for tangible personal property which meets the intended purpose of the contribution before the end of the second taxable year ending after the taxable year in which the contribution was received. A contribution received in aid of construction (or any property constructed or acquired with such contributions) may not be included in the utility's rate base for rate-making purposes. Contributions in aid of construction may not include customer connection fees including amounts paid to connect the customer's line to an electric line, a gas main, a steam line, or a main water or sewer line, and amounts paid for starting and stopping services.[22]

No deductions are allowable with respect to a contribution in aid of construction, and property purchased with contributions in aid of construction has no depreciable tax basis and is not eligible for the investment tax credit.[23]

2. Reasons For Change

In an abrupt about-face from its position enunciated in enacting §118(b) in the Tax Reform Act of 1976, the House Ways and Means Committee believes that all payments made to a utility either to encourage, or as a prerequisite for, the provision of services should be treated as taxable income of the utility and not as contributions to capital. The Committee stated that contributions in aid of construction represent prepayments for future services to be rendered by regulated utilities which are never included in income.[24]

B. Detailed Analysis

1. General Rule

TRA 1986 amends §118(b) so that regulated public utilities may no longer exclude from income contributions in aid of their construction which have not been included in their rate base. Thus, a utility must include in gross income the value of any property that it receives to provide, or encourage the provision of, services to, or for the benefit of, the person transferring the property. Such transactions often will involve a builder transferring equipment, improvements to land, or money to fund such items to a utility to facilitate the provision of utility services to property constructed by the builder.

The House Report indicates that a utility is considered to have received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of services, if the receipt of the property results in the provision of services earlier than would have been the case had the property not been received, or if the receipt of the property otherwise causes the transferor to be favored in any way.[25] It does not matter that a utility has a general

[12] *Id.*
[13] Act §821(b)(3).
[14] H.R. Rep. No. 841, 99th Cong. 2d Sess. II-323 (1986) (hereinafter referred to as the "Conf. Rep.")
[15] Act §821(b)(1).
[16] Act §821(b)(2).
[17] Conf. Rep. at II-323.
[18] Conf. Rep. at II-323-4.
[19] Footnote 1, *supra.*
[20] §118(a).
[21] §118(b)(1).
[22] §118(b)(3)(A).
[23] §118(b)(4). *See* §362(c)(3).
[24] H.R. Rep. No. 426, 99th Cong., 1st Sess. p. 643-4 (1985) (hereinafter referred to as the "House Report.")
[25] House Report at 644.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

policy, stated or unstated, that only requires or encourages certain types of potential customers to transfer property, including money, to the utility while other types of potential customers are not required to encouraged to make similar transfers. If members of a group making transfers of property are favored over other members of the same general group not making such transfers, the fact that the contributing members of the group may not be favored over the members of other groups in receipt of services will not prevent the inclusion of the value of the transfer in the utility's income.[26]

Example: If a utility generally requires developers of multiple tracts of residential housing to transfer property to the utility in order to obtain service, but does not require such a transfer from individual homeowners, the fact that both groups will receive service without preference of one group over the other will not prevent the utility from being required to include in income the value of the property received from the developers.

Where all members of a particular group make transfers of property to the utility, normally it will be presumed that such transfers are to encourage the provision of services, despite the absence of any formal policy requiring such transfers, unless it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfers.[27]

The person transferring the property will be considered as having been benefited if he is the person who will receive the services, an owner of the property that will receive the services, a former owner of the property that will receive the services, or if he derives any benefit from the property that will receive services. House Report at 644.

Example: A builder who transfers property to a utility in order to obtain services for a house that he was paid to build on the property of another will be considered as having benefited from the provision of the services even though he may have never had an ownership interest in the property upon which he was building and may make the transfer to the utility after the house has been completed and accepted by its purchaser.[28]

2. Effective Date

Generally, contributions in aid of construction received after December 31, 1986, in taxable years ending after such date, must be included in income. Act §824(c).

III. Technical Corrections to the Tax Reform Act of 1984 Affecting Accounting Methods

A. Clarification of Cash Basis Exception to Tax Shelter Rule — §461(i)(2)

1. Introduction

Generally a cash basis tax shelter is not allowed a deduction with respect to any item any earlier than the time at which economic performance occurs.[29] An exception is provided under which prepaid expenses are deductible when paid if economic performance occurs within 90 days after the close of the taxable year and the tax shelter has sufficient cash basis to cover such deduction.[30] For purposes of this exception, economic performance with respect to the drilling of an oil and gas well will be treated as occurring when the drilling of the well commences. It is unclear whether the exception applies if economic performance occurs before the close of the taxable year because this is not "within 90 days after the close of the taxable year." For example, it is unclear whether the exception applies if a well is drilled, or economic performance occurs with respect to any other deduction, in the last month of the taxable year.

2. Detailed Analysis

TRA 1986 clarifies that the exception for items for which there is economic performance within 90 days after the close of the taxable year applies if economic performance occurs before the close of the 90th day after the close of the taxable year.[31] Thus, for example, if a well is drilled in the last month of the taxable year, the requirement that economic performance occur before the close of the 90th day after the close of the taxable year is satisfied. This provision is effective as if included in §461(i) when originally enacted.[32]

B. Clarification of Application of §464 in §461(i)(2)

1. Introduction

The farming syndicate rules of §464 apply to any tax shelter described in §6661(b)(2)(C)(ii) (*i.e.* an entity or arrangement the principal purpose of which is the avoidance or evasion of federal income tax) which is engaged in the trade or business of farming.[33] For purposes of applying §464 to these farm business tax shelters, it is unclear whether the exceptions under §464(c)(2), relating to holdings attributable to active management, apply in determining if the entity is a tax shelter.

2. Detailed Analysis

The technical corrections in the 1986 TRA clarify that any tax shelter described in §6661(b)(2)(C)(ii) which is engaged in the trade or business of farming generally will be treated as a farming syndicate for purposes of §464.[34] However, any person meeting the requirements of §464(c)(2) will not be subject to the provisions of §464 with respect to that person's interest in a tax shelter. Section 464(c)(2) defines the holdings in a farming syndicate which are attributable to active management, and therefore, will not be subject to the rules of §464. Such person's interest will still be subject to the restrictions in §461(i).

This provision is effective as if included in §461(i) when originally enacted.[35]

---

[26] *Id.*
[27] *Id.*
[28] House Report at 644-5.
[29] §461(i)(1).
[30] §461(i)(2).
[31] Act §1807(a)(1) amending §461(i)(2)(A).
[32] Act §1881.
[33] §461(i)(4).
[34] Act §1807(a)(2).
[35] Act §1881.

C. *Treatment of Mining and Solid Waste Reclamation and Closing Costs*

1. *Introduction*

The 1984 TRA provided electing taxpayers with a uniform method for deducting, before economic performance, certain reclamation costs which were mandated by federal, state or local law.[36] Deductions accrued under this method were accounted for in a book reserve and were subject to recapture to the extent that reclamation costs were less than accumulated reserves. §§468(a)(2)(C) and (a)(3).

2. *Detailed Analysis*

The 1986 TRA clarifies that the reserve balance created by taxpayers which have elected to deduct mining and solid waste reclamation and closing costs before economic performance under §468 must be increased by the amount of deductions accrued in each year that are allocable to the reserve.[37] Without this clarification, taxpayers may have taken a double deduction for such expense (*i.e.*, once as an addition to the reserve and once as an expense not covered by the balance in the reserve) because there was no specific increase of the reserve for the current deductions taken.

The Act also clarifies that §468 is effective for deductions incurred after July 18, 1984, for taxable years ending after July 18, 1984.[38]

D. *Treatment of Decommissioning of Nuclear Power Plants*

1. *Introduction*

The Tax Reform Act of 1984 permitted electing taxpayers to accrue a deduction for contributions made to a qualified nuclear decommissioning fund, subject to certain limitations.[39]

2. *Detailed Analysis*

TRA 1986 clarifies that a taxpayer shall be deemed to have made a payment to a nuclear decommissioning fund on the last day of a taxable year provided that such payment is made within two and a half months after the close of that taxable year.[40] Under a transition rule, Treasury has the regulatory authority to relax, and appropriately adjust, the two and a half month rule for payments allocable to a taxable year beginning before January 1, 1987. Thus, payments before December 31, 1986 may qualify as payments to a nuclear decommissioning fund for prior taxable years. Treasury may decrease the amount of the deduction allowed the taxpayer to reflect the fact that the payment was made more than two and one-half months after the close of the taxable year. Though the wording is very obscure, it appears that any reduction in the income tax of the taxpayer because a payment more than two and one-half months after the close of the taxable year is attributed to a prior taxable year will be refunded to the taxpayer without any interest payable by the IRS for the period before the payment.[41]

The technical correction clarifies that the deductions of a fund are like those deductible by a corporation and that the tax treatment of fund income provided in §468A is in lieu of any other federal income tax.[42] A fund's tax liability is not deductible from its gross income, and, for purposes of subtitle F (Procedure and Administration), a fund shall be treated as a corporation and the tax imposed on the fund shall be treated similarly to the corporate income tax.[43] The 1986 TRA clarifies that a fund may invest only in those assets in which a Black Lung Trust Fund may invest.[44] This was necessitated because the Senate Report to the 1984 Tax Reform Act indicated that these were the investments allowed for a fund.[45] The statute, however, did not contain such a limitation. The bill also clarifies that this provision is effective for taxable years ending after July 18, 1984.[46]

E. *Effective Date for Net Operating Loss Provisions*

1. *Pre-1986 TRA Law*

The Tax Reform Act of 1984 amended §172(b), which specifies those years to which net operating losses may be carried, to allow a 10-year carryback in the case of a deferred statutory or tort liability loss for any taxable year beginning after December 31, 1983.

2. *Detailed Analysis*

The 1986 TRA adds a technical correction which confirms that the effective date for the amendment to §172(b) in the Tax Reform Act of 1984 was for losses for taxable years beginning after December 31, 1983.[47]

F. *Clarification of Rules for Earlier Effective Date for Economic Performance Rules — §461(h)*

1. *Introduction*

Section 91(g)(2) of the Tax Reform Act of 1984, as corrected before enrollment, provided a method for taxpayers to elect to have the earlier application of the changes in §461(h), relating to deduction of costs after economic performance, apply. The election applied to costs incurred "before" the enactment of the Act without regard to the amendments of 1984 TRA, and costs incurred "on or after" the date of enactment with regard to the amendments. However, the 1984 TRA actually applied to costs incurred after the date of enactment without regard to the amendments.[48]

2. *Detailed Analysis*

To clarify the election for early application of §461(h) allowed under §91(g)(2) of the Tax Reform Act of 1984, the 1986 TRA specifies that the election applies to costs incurred "on or before" the enactment of the Act without regard to the amendment of §461(h), and costs incurred "after" the date of enactment with regard to the amendment.[49] This election is known as the part year change in

[36] §468(a).
[37] §468(a)(2)(D), as added by Act §1807(a)(3)(A).
[38] Act §1807(a)(3)(B).
[39] §468A.
[40] §468(g), as added by Act §1807(a)(4).
[41] *See* Sen. Rep. at 928. Act §1807(a)(4)(a)(ii).
[42] §468A(e)(2)(A)(ii) and 468A(e)(2)(B).
[43] §468A(e)(2)(C).
[44] §468A(e)(4)(C).
[45] *See* Sen. Rep. No. 169 (Vol I), 98th Cong. 2d Sess. 278-9 (1984).
[46] Act §1807(a)(4)(F).
[47] Act §1807(a)(6).
[48] Tax Reform Act of 1984, P.L. 98-369. Act §91(g)(1).
[49] Act §1807(a)(6).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

method in the temporary regulations governing effective dates for §461(h).[50]

Under Act §1807(a)(6), Treasury can prescribe regulations to provide that taxpayers may elect to have §461(h) apply to their entire taxable year in which occurs July 19, 1984. This amendment was made because the temporary regulations issued by Treasury allowed such an election and it was not clear that it had statutory authority to do so.[51]

G. Special Rules for Designated Settlement Funds

1. Introduction

The 1984 TRA provided that liabilities were not treated as incurred before the time when economic performance occurred.[52] In the case of the taxpayer's liability to another person arising under any workers' compensation act or any tort, economic performance occurred as payments to such person were made, except to the extent provided in regulations.[53] It was unclear whether an irrevocable payment to a court ordered settlement fund, which extinguished the tort liability of the taxpayer to a person (or class of persons), constituted economic performance under §461(h).

2. Overview

The 1986 TRA allows payments made to a court-ordered settlement fund which extinguishes the taxpayer's tort liability to be considered economic performance of that liability and thus allows a current income tax deduction for the taxpayer's payment. The fund, which must be comprised entirely of qualified payments, must be managed and controlled by a majority of persons unrelated to the taxpayer and may not allow the taxpayer any interest in the income or principal of the fund. A designated settlement fund may not be created for any workers' compensation liability or any contested liability.

A qualified payment may not consist of stock or indebtedness of the taxpayer or a related party. The fund is a separate taxpayer and will be taxed on its income at the maximum tax rate for trusts. Payments to the fund are not taxable to the fund and distributions to beneficiaries are not deductible by it. No deduction is allowed a taxpayer if it received an amount as settlement of an insurance claim, excluded that amount from income, and used those funds to create the settlement fund. Payments to a trust or escrow fund other than a designated settlement fund do not constitute economic performance with respect to the tort liability of a taxpayer.

3. Detailed Analysis

a. General Rule

The technical correction portion of the 1986 TRA clarifies that under certain limited circumstances, an irrevocable payment to a court-ordered settlement fund that extinguishes tort liability of the payor constitutes economic performance with respect to such liability.[54] This provision applies only to qualified payments made to a designated settlement fund.

A "designated settlement fund" means a fund (1) which is established pursuant to a court order, (2) which is established for the principal purpose of resolving and satisfying present and future claims against the taxpayer (or any related person, within the meaning of §267(b), or formerly related person) arising out of personal injury, death or property damage, (3) which is administered by persons a majority of whom are independent of the taxpayer, (4) in which the taxpayer does not have a beneficial interest in the income or corpus, (5) to which no amount may be transferred other than qualified payments and (6) for which the taxpayer has made an election.[55] The Senate Report indicates that in meeting these requirements the fund must completely extinguish the taxpayer's tort liability with respect to a class of claimants, as determined by the court.[56] The election must be made in accordance with regulations set out by Treasury, and once made, can only be revoked with the Treasury's consent.[57]

A qualified payment means cash or property, other than stock or indebtedness of the taxpayer (or a related party), which is irrevocably contributed to a designated settlement fund pursuant to a court order, or any amount which may be transferred from the fund to the taxpayer.[58]

A designated settlement fund is not qualified if the taxpayer may benefit from the corpus or income of the fund. §468B(d)(2)(E).

> *Example*: If the taxpayer's future liability to claimants (or other parties) is contingent on the income of a settlement fund created by the taxpayer, then the taxpayer may benefit from the fund's income, and the fund is not a qualified designated settlement fund.[59]

A designated settlement fund is taxed as a separate entity at the maximum rate for income of trusts under §1(e).[60] Gross income of a designated settlement fund includes income from investment of fund assets, but excludes qualified payments made to the fund.[61] No deductions are permitted except for administrative costs (including State and local taxes) and incidental expenses of the designated settlement fund (including legal, accounting and actuarial expenses) that are incurred in connection with the operation of the fund and which would be deductible in determining the taxable income of a corporation.[62] Distributions to claimants are not deductible but are treated as having been made by the taxpayer for purposes of determining the claimant's taxable income.[63]

The Senate Report indicates that a contribution of property to a designated settlement fund is treated as if the taxpayer sold the property for fair market value and donated to the proceeds to the fund. Thus, the taxpayer's deduction is equal to the property's fair market value. The

---

[50] Regs. §1.461-3T Q&A-2.
[51] *Id.*
[52] §461(h).
[53] §461(h)(2)(C).
[54] Act §1807(a)(7); §468B(a).
[55] §468B(d)(2).
[56] Sen. Rep. at 926.
[57] §468B(d)(2).
[58] §468B(d)(1).
[59] Sen. Rep. at 926.
[60] §468B(b)(1). For a discussion of the income tax rates for trusts, *see* Chapter 47, *infra.*
[61] Sen. Rep. at 926.
[62] §468B(b)(2).
[63] Sen. Rep. at 926 and Conf. Rep. at II-844.

taxpayer recognizes gain or loss at the time property is contributed, and the fund takes a fair market value basis in the property.[64]

No deduction is allowed for any qualified payment by a taxpayer to a fund of an amount received from the settlement of an insurance claim, to the extent the amount received is excluded from the taxpayer's gross income.[65] Payments to a trust or escrow fund, other than a designated settlement fund, do not constitute economic performance with respect to any tort liability of the taxpayer, unless provided otherwise by Treasury regulations.[66] The amendment, however, does not affect the treatment of payments made for certain personal injury liability assignments within the meaning of §130 to a third party who assumes responsibility for making such payments.[67]

These provisions do not apply to liability arising from any workers compensation act or contested liabilities (within the meaning of §461(f)). §468B(e). The Senate Report states that no inference about the current law treatment of such liabilities is intended.[68]

The technical correction also states that nothing in any provision of law shall be construed to provide that an escrow account, settlement fund or other similar fund is exempt from current income tax. If nondeductible contributions are made to such funds, the accounts or funds will be taxed as grantor trusts.[69] This provision reverses the Service's position in Rev. Rul. 71-119,[70] wherein it concluded that a United States District Court was not a fiduciary with respect to a settlement fund which it held and was not required to file a fiduciary income tax with respect to the income of the fund. This provision applies to accounts and funds established after August 16, 1986.

b. Effective Date

The general effective date for the technical corrections covers this provision and therefore this amendment will take effect as if included in the provision of the Tax Reform Act of 1984 to which it relates (*i.e.*, 1984 TRA §91).[71] Therefore, the amendment is effective for payments which would have been deductible after July 18, 1984 without regard to the amendments in §461(h).

H. Amendment of Treatment of Services

1. Introduction

Under §467(g), as added by TRA 1984, Treasury is to prescribe regulations under which deferred payments for services will be subject to rules similar to those applicable to deferred rents.

2. Detailed Analysis

The technical corrections clarify that the regulations to be issued under §467 (relating to deferred payments for services) will not apply to amounts to which §404 or 404A (relating to pension cost deductions) apply, or to amounts subject to any other provision specified in regulations.[72]

---

[64] Sen. Rep. at 926; §468B(b)(3)(B).
[65] §468B(c).
[66] §468B(f).
[67] Conf. Rep. at II-844.
[68] Sen. Rep. at 926.
[69] Act §1807(a)(7)(D).
[70] 1971-1 C.B. 163.
[71] Act §1881.
[72] Act §1807(b)(1); §467(g).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 25

EXPANDED RELATED PARTY RULES

Samuel M. Maruca,Esq.
Silverstein and Mullens
Washington, D.C.

I. Background

The Internal Revenue Code limits the availability of certain tax benefits in transactions between related parties. The primary purpose of these limitations is to prevent taxpayers from generating tax benefits where there is an identity of economic interests between the parties. For example, Code §267, the principal related party provision, describes a number of relationships between seller and purchaser (or payor and payee, in the case of certain otherwise deductible expenditures) that will result in a disallowance of losses (or deductions) on the transfer (or payment).

Other situations in which the related party rules apply are: sales of depreciable property (§1239); sales or exchanges of property between a partner and a controlled partnership, or between commonly-owned partnerships (§707); and subsequent dispositions of property acquired in installment sales (§453(e)).

II. Overview and Effective Dates

The 1986 TRA tightens significantly the rules governing sales of property between related persons by expanding applicable definitions of "related persons."

Code §1239, which prescribes ordinary income treatment for gain on sales of depreciable property between related persons, is amended by reducing from 80% to 50% the percentage ownership that results in application of the rule. Certain relationships described in Code §267(b) are incorporated, as are the constructive ownership rules in Code §267(c).

Similarly, TRA 1986 amends Code §707(b)(2) to provide for ordinary income treatment on sales of certain property between a partner and the partner's 50%-owned partnership, and between two partnerships of which the same person or persons own 50%.

The Act makes comparable changes in the definition of related persons for purposes of accelerated recognition on the disposition of property sold on the installment method (Code §453(f)). In addition, the rules proscribing installment treatment for sale of depreciable property under §1239(b) are clarified with respect to contingent payments. For this purpose, new §453(b)(8) provides that payments to be received for property include the aggregate of fixed payments plus the fair market value of contingent payments.

Observation: Due to the elimination of the capital gains exclusion, many of these new rules will have blunted effect in 1987 and no effect thereafter (unless the rate differential is reintroduced).

The amendments generally apply to sales after October 22, 1986, in taxable years ending after that date. The amendments do not apply, however, in the case of sales closed after August 14, 1986, pursuant to a binding contract in effect on that date and at all times thereafter.

III. Detailed Analysis

A. Sales of Depreciable Property

The Act amends Code §1239(b)(1) by eliminating the reference to "80-percent owned entities" and adopting the concept of "controlled entities" in lieu thereof.[1] Code §1239(c)(1), in turn, is amended to provide a definition of "controlled entity". A "controlled entity," with respect to any person, now includes (i) a corporation more than 50% of the value of the outstanding stock of which is owned, directly or indirectly, by or for such person, and (ii) a partnership more than 50% of the capital interest or profits interest in which is owned, directly or indirectly, by or for such person.[2]

In addition, Act §§642(a)(1) expands the reach of §1239 by including in the definition of "controlled entity" a number of the relationships described in §267(b), and by broadening the applicable attribution rules. Thus, under §1239(c)(1)(C) the following persons are considered related for purposes of §1239:

(1) two corporations that are members of the same controlled group;[3]

(2) a corporation and a partnership if the same persons own more than 50% in value of the outstanding

---

[1] Act§642(a)(1)(A).
[2] Act §642(a)(1)(B); Code §1239(c)(1).
[3] "Controlled group" follows the definition under the consolidated return rules (§1563), except that cross ownership of more than 50% ownership (as opposed to 80%) of either total voting power or total stock value of group members is sufficient to constitute a controlled group. *See* Code §§267(f)(1) and 1563(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

stock of the corporation and more than 50% of the capital or profits interest in the partnership;

(3) an S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation; and

(4) an S corporation and a C corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.[4]

Moreover, Act §642(a)(10(C) replaces the stock attribution rules applicable under §1239. Prior to enactment of the 1986 TRA, the attribution rules contained in §318(a) generally applied for §1239 purposes. Now, §1239(c)(2) includes §267(c) rules, with certain modifications, to apply as follows:

(1) ownership of stock by an entity (*i.e.*, by a corporation, partnership, estate or trust) is attributable to the owners in proportion to their interests in the entity; and

(2) an individual is treated as owning stock owned by his family (with the term "family" defined to include siblings by whole or half blood, spouse, ancestors and lineal descendants). Section 267(c)(5) provides special rules to limit multiple attributions under alternative constructive ownership rules.

Observation: The most significant change in the §1239 attribution rules is that an individual's siblings, ancestors and lineal descendants are now part of the attribution group. Previously, attribution applied only between spouses.

B. Partnerships

Section 707(b)(2) provides for ordinary income treatment on the sale or exchange of certain property between a partner and the partner's controlled partnership. The rule applies in the case of property that is not considered a capital asset as defined in §1221, in the hands of the transferee.

Prior to the Act, §707(b)(2) treated partnerships as controlled partnerships if the partner owned more than 80% of the capital or profits interest, or if the same persons owned such interests (in the case of two or more controlled partnerships). The Act amends §707(b)(2) such that ownership of a more than 50% capital or profits interest triggers ordinary income treatment.[5]

The Act makes two technical changes relating to partnership related party transactions.[6] First, for sales or exchanges after September 27, 1985, §707(b)(1)(A) and §707(b)(2)(A) apply whether or not the person constructively holding a 50% interest is himself a partner. This effectively allows §707(b)(1)(A) to override §267(a)(1) in situations where constructive owners are considered to own more than 50% of the capital or profits interests in the partnership.[7]

Second, the Act amends §707(b) to provide that the deferral provisions of §267(a)(2) apply to transactions involving two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests. This change is intended to replace Temp. Regs. §§1.267(a)-2T(c), questions 2 and 3, drafted pursuant to the Tax Reform Act of 1984.[8]

C. Installment Sales

1. In General

Act §642(a)(3) modifies the definition of related persons for purposes of accelerated recognition on the disposition of property sold on the installment method under §453(e).

Prior to the Act, relationships that caused accelerated recognition included only those specific in §318(a) (other than §318(a)(4)). The definition of "related person" under §453(f) now encompasses not only the relationships specified in §318(a), but also those enumerated in §267(b) (consisting of 12 additional specific relationships). Thus, for example, siblings, members of the same controlled group of corporations, and a grantor and fiduciary of a trust, are considered related for §6453 purposes. Accordingly, where a sibling disposes of property acquired from another sibling in an installment rule and the purchaser disposes of the property before all payments are received by the seller, amounts received on the second disposition are treated as received at that time by the seller.[9]

2. Contingent Payments

Act §6129b) amends the §453(g) rules proscribing installment treatment of §1239(b) transactions with respect to contingent payments. For this purpose, payments to be received for property include the aggregate of payments that are fixed as to amount, plus the fair market value of payments that are contingent as to amount.[10]

If the fair market value of contingent payments "may not be reasonably ascertained", the Act stipulates that the seller's basis is to be recovered ratably, and the purchaser may not increase its basis in the property by any amount before such time as the seller includes commensurate amounts in income.[11]

Observation: The Act does not specify precisely how the seller's basis is to be recovered. Presumably, if an installment sales contract calls for any contingent payments, basis must be recovered ratably over the term of the contract, even though the bulk of the purchase price (as finally determined) is fixed in amount and payable prior to contingent amounts.

Query: How is the seller's profit ratio to be determined?

---

[4] Act §642(a)(1)(B)(iv); Code §1239(c)(1)(C).
[5] Act §642(a)(2); Code §707(b)(2)(A) and (B).
[6] Act §1812(c)(3). *See* H.R. Rep. No. 426, 99th Cong., 1st Sess. 939-40 (1985) ("House Report").
[7] *See* Regs. 1.707-1(b)(3) for an illustration of the interrelation between §707(b)(1)(A) and §267(a)(1) prior to the 1986 Act.
[8] *See* House Report at 940.
[9] Code §453(e).
[10] Act §642(b)(1); Code §453(f)(8).
[11] Act §642(b)(2); Code §453(g)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 26

TAX STRADDLES

Harrison B. McCawley, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

The 1986 Tax Reform Act contains several amendments relating to the Code's tax straddle provisions (§§263(g), 1092 and 1256).[1]

Act §331 expands the so-called "year-end rule" of §1092(c)(4)(E).

Act §1808 makes four "technical corrections" to provisions enacted by the Tax Reform Act of 1984.[2] Of these, by far the most significant is the amendment to §108 of the Tax Reform Act of 1984, which is the subject of several Tax Court decisions. The other technical corrections are relatively minor.

II. Amendment of the "Year-End Rule"

Section 1092(c)(1)[3] defines a "straddle" as "offsetting positions with respect to personal property." Excepted from this definition is a straddle made up of offsetting positions consisting of one or more qualified covered call options and the stock to be purchased from the taxpayer under such options where the straddle is not part of a larger straddle.[4] A "qualified covered call" is, generally, an option granted by the taxpayer to purchase publicly traded stock held by the taxpayer.[5] It must have an expiration date more than 30 days from the date it was granted and cannot be a "deep-in-the-money option." Excluded are options granted by a dealer in connection with his activity of dealing in options. Finally, gain or loss with respect to the option must not be ordinary income or loss.[6]

For an option not to be deep-in-the-money, its strike price (*i.e.*, the price at which the option is exercisable) must not be lower than the "lowest qualified bench mark." §1092(c)(4)(C). The qualified covered call exception from the straddle provisions of §1092 recognizes that in most circumstances, the granting of a covered call is a transaction whose purposes in no way involve the abuses the straddle provisions were enacted to prevent, *i.e.*, to create what are in effect economically artificial losses which can be offset against income unrelated to the property involved in the straddle transaction and/or to defer the payment of tax on economic gain from one taxable year to the next. Where the option's strike price is equal to or only slightly lower than the price at which the covering stock is traded at the time the option is granted, it is almost impossible to manipulate the offsetting positions in such a way as to obtain the tax advantages described. The purposes of granting such an option are: (1) to protect, to the extent of the premium received, the value of the underlying stock against a decline in its price, and (2) to enhance the yield of the stock by retention of the premium received in the event the option expires without being exercised.

It was seen, however, that in the event the price of the stock moved upward, the grantor of the covered call could, at the end of the year, enter into a closing transaction (which amounts to the purchase of an offsetting call option), terminating his obligation thereunder at a loss. In other words, to close out the option, he would have to purchase the offsetting option at a price in excess of the amount of the premium received. The grantor could then dispose of the appreciated stock a few days later after the end of the year. This maneuver would permit the realization of a deductible loss while, in substance, maintaining a balanced position, permitting the deferral of tax on unrelated income.

To prevent this, §1092(c)(4)(E), prior to its amendment by the 1986 Act, provided a "special year-end rule," under which the above-described exception from the §1092(a) straddle rules did not apply in the above described circumstances where (1) the covered call was closed in one taxable year, and (2) gain on disposition of the covering stock was includible in income for a later taxable year unless the covering stock was held for 30 days or more after the closing of the option.

This rule did not, however, apply to prevent a similar abusive manipulation where the stock *declined* in value. The stock could be sold at a loss at year-end and the option closed (or, if the expiration date was near, allowed to expire unexercised) at the beginning of the succeeding year. To

---

[1] Two of these amendments, made by Act §1261(b) and (c), relate to foreign currency transactions. These are discussed in Chapter 60 of this portfolio.

[2] Act §1808 is contained in Act Title XVIII — Technical Corrections, subtitle A — Amendments Related to the Tax Reform Act of 1984.

[3] All references to sections, unless otherwise stated, are to sections of the Internal Revenue Code of 1986 and/or to its predecessor, the Internal Revenue Code of 1954.

[4] §1092(c)(4)(A).

[5] *See* §1092(c)(4)(B), which defines the term "qualified covered call option."

[6] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

correct this, Act §331, effective as to positions established on or after January 1, 1987, expanded the year-end rule so that it applies in there circumstances as well. Thus, in addition to the pre-1986 TRA rule of §1092(c)(4)(E), set forth above, where the covering stock is disposed of at a loss during any taxable year, and gains on the covered option(s) are includible in gross income for a later taxable year, and where such option was not held by the taxpayer for 30 days or more after the disposition of the stock, the qualified covered call exception to the definition of straddle is inoperative with respect to the positions described.

III. Amendments Relating to Foreign Currency Transactions

Section 1261(b) of the Act adds paragraph (7) to §1092(d) providing that for purposes of paragraph (2) (defining the term "position" as an interest, including a futures or forward contract or an option, in personal property), an obligor's interest in a nonfunctional currency denominated debt obligation is treated as a position in the nonfunctional currency. Thus, where a U.S. corporation (whose functional currency is the dollar) is the obligor of a note denominated in Swiss Francs, the acquisition of a long position in Swiss Francs will give rise to a straddle. Unless specifically excepted by some other statutory provision, the loss deferral rules of §1092 will apply to the straddle positions.

Under the rules of §988(a)(1), added by Act §1261(a), except as provided in regulations, a taxpayer may elect to treat any foreign currency gain or loss attributable to a forward contract, a futures contract, or option described in subsection (c)(1)(B)(iii) which is a capital asset in the hands of the taxpayer as a capital gain or loss. This election does not apply, however, to a position which is part of a straddle within the meaning is §1092(c) (without regard to the qualified covered call exception of §1092(c)(4)). Subsection (c)(1)(B)(iii) (part of the definition of a "§988 transaction") refers to positions which are not marked to market at the close of the year under §1256. Further §988(d)(1) provides that neither §1092 nor §1256 applies to a "§988 hedging transaction."

Section 1092(d)(7), as added by the Act, also provides that foreign currency for which there is an active interbank market is treated as "actively traded" for purposes of §1092(d)(1).

Section 1261(c) of the Act repeals §1256(e)(4) which provided that in the case of a bank, the requirements of §1256(e)(2)(A)(i) and (ii) need not be met for transactions entered into by such bank to qualify as "hedging transactions."

The interaction between these amendments to the straddle provisions and the 1986 TRA provisions relating to foreign currency transaction is discussed in Chapter 60.

IV. Amendments to §108 of the 1984 TRA

A. Section 108 of P.L. 98-369 and the Miller Decision

At the time P.L. 98-369 (Tax Reform Act of 1984) was being drafted, the IRS had issued a large number of deficiency notices disallowing losses based on transactions similar to those involved in Rev. Rul. 77-185, 1977-1 C.B. 48. In *Smith v. Comr.*, 78 T.C. 350 (1982), the Tax Court rejected the Commissioner's contention, based on this ruling, that the disposition of the loss leg of a straddle accompanied by its simultaneous replacement, locking in the unrealized gain from the gain leg, was not a completed transaction and thus did not give rise to loss recognizable under §165(c). The court did agree, however, with the alternative position that no loss was allowable because the transaction, concededly not entered into in the course of the taxpayer's trade or business, was not sustained in a transaction entered into for profit as is required by §165(c)(2). Not only was profit not the principal motive for entering into the transaction, but the evidence abundantly established that the taxpayer anticipated an overall pre-tax benefit loss since the out of pocket expenses (commissions, fees, etc.) exceeded any foreseeable gain from the hedged positions involved. In *Fox v. Comr.*, 82 T.C. 1001 (1984), involving straddles composed of put options on Treasury bills, *Miller* was followed in disallowing losses sustained in transactions which the court found were motivated primarily by anticipated tax benefits rather than economic profit. In that case, the court indicated in a dictum that the primarily for profit interpretation of §165(c)(2) might not apply where the tax motivated transaction in question was one which Congress intended to encourage.

The IRS did not, however, abandon its position that the disposition of the loss leg of such a straddle was not a completed or closed transaction, a position which, if ultimately sustained, would result in the disallowances of straddle losses even in cases involving professional traders acquiring straddle positions with a profit motive, *i.e.*, hoping to derive a profit from a favorable increase (or decrease) of the price spread. This led Congress to enact §108 of the Tax Reform Act of 1984.[7] Section 108(a) provided that "in the case of the disposition of 1 or more positions—

> (1) which were entered into before 1982 and form part of a straddle, and
>
> (2) to which the amendments made by title V of [ERTA] do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such disposition is part of a transaction entered into for profit."

Section 108(d) in effect foreclosed the IRS from disallowing such straddle losses under the lack of closed transaction theory. In other words, as to straddle positions to which the ERTA provisions did not apply, the only ground for disallowance was the lack of a profit motive with respect to the transaction of which the loss position was a part. In addition, §108(b) provided that "any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit." A "commodities dealer" was defined in §108(f) as having the meaning given such term by Code §1402(i)(2)(B).

[7] Reference to "§108" in the discussion below is to this section of P.L. 98-369 and not to a Code section as are all other references to sections.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The scope and application of §108 was interpreted by the IRS in Temp. Regs. §1.165-13T. These regulations, which are in question and answer format, state (in A-2) that for §108 to apply, "the transaction must have sufficient substance to be recognized for Federal income tax purposes. Thus, for example, since a 'sham' transaction would not be recognized for tax purposes, §108 of the Act would not apply to such a transaction."

In *Miller v. Comr.*, 84 T.C. 827 (1985), involving Rev. Rul. 77-185 type straddle losses which, for all practical purposes, were indistinguishable from those involved in *Smith*, the taxpayer was successful in persuading the Tax Court that if the futures prices had moved in certain (admittedly unlikely) ways, a profit could have been realized, albeit substantially less than the benefits resulting from the deferral of tax. The court, after concluding that the straddle transactions were entered into primarily for their anticipated tax benefits, and that, absent §108 *Smith* would require disallowance of the claimed losses, concluded that the words "entered into for profit" as used in §108 did not have the same meaning as when used in §165(c)(2) as interpreted in the *Smith* and other decisions involving the statute. The Conference Report, H.R. Rep. No. 861, 99th Cong., 2d Sess. 1984-3 C.B. (Vol. 2) 1, 171 states, "[i]n determining whether the position is part of a transaction entered into for profit, it is intended that the provision be applied by treating the condition as satisfied if there is a reasonable prospect of any profit from the transaction." Since the court found that there was a reasonable prospect for profit, it held, in a reviewed opinion over a vigorous dissent by Judge Simpson and others, that the losses must be allowed under §108.

In *Miller*, the court rejected the Government's contention that the transactions involved were shams. In so doing, it appeared to equate "sham" with quasi fraud of the type involved in *Julien v. Comr.*, 82 T.C. 492 (1984), where the taxpayer was unable to present convincing evidence that the purported straddle transactions had ever actually been entered into in his behalf. If, on the other hand, the term as used in the regulations meant imbued with sufficient economic substance, apart from the tax benefits anticipated, to be entitled to recognition for tax purposes, as in *Knetsch v. U.S.*, 364 U.S. 361 (1960) (deduction for prepaid interest denied where loan proceeds used to purchase single premium annuity which was cashed in at the end of the succeeding year — a deferral scheme under which the taxpayer "loaned money to himself"), the court ruled that they were in conflict with *Smith* (where the lack of economic substance argument was rejected) and with §108, which contains no mention of economic substance. The court's interpretation of "entered into for profit" was applied in *Landreth v. Comr.*, T.C. Memo 1985-413; *Kurtz v. Comr.*, T.C. 1985-410, and *Perlin v. Comr.*, 86 T.C. 388 (1986). In each case the court found that the taxpayers had some reasonable expectation of profit.

B. 1986 TRA Amendments to §108(a): The London Options Cases

The holding in *Miller*, which effectively granted amnesty to thousands of taxpayers whose losses based on dispositions of pre-1982 straddle positions had been challenged by the IRS, was a matter of considerable concern to the IRS and, apparently, to Congress. After *Miller*, the Tax Court held in *Brown v. Comr.*, 85 T.C. 968 (1985) that a straddle scheme (in which, similar to the facts in *Julien*, *supra*, investors were provided by the promoter with schedules showing transactions purportedly carried out on their behalf) involved sham transactions since there was no evidence that the transactions had ever actually been effected. Similar sham transactions were found to exist in *Forseth v. Comr.*, 85 T.C. 127 (1985) and *Martino v. Comr.*, T.C. Memo 1986-263, both of which involved "factual shams," *i.e.*, prearranged or fictitious transactions involving rigged prices. These cases are, therefore, distinguishable from *Smith* or *Miller* in that they involved what may be termed shams in fact. In no decision prior to the 1986 Act amendments to §108, discussed below, had it ever been held that a straddle transaction was a sham in substance, that is, that it should not be recognized for tax purposes because it lacked economic substance, the argument rejected by the Tax Court in *Smith*.

As part of the 1986 Tax Reform Act, Congress amended §108, effective as if enacted by ERTA.[8] The language of §108(a), quoted above, "if such position is part of a transaction entered into for profit," was stricken out and the following was inserted: "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business." This language is similar to that of §165(c)(2).

The House Report makes it clear that the intent of this language is to overrule the Tax Court's *Miller* decision: "It was not the intent of Congress in enacting §108 to change the profit motive standard of §165(c)(2) or to enact a new profit motive standard for commodity straddle activities. This technical correction is necessary to end any additional uncertainty created by the *Miller* case."[9] However, the Conference Committee Report makes no mention of *Miller* or of any intention to change the meaning of "entered into for profit," as used in §108(a) prior to its amendment.[10]

The effect of the amendment was quickly tested in *Glass v. Comr.*, 87 T.C. No. 68 (Nov. 17, 1986), a reviewed decision involving over a thousand petitioners whose cases were consolidated and who carried on their transactions through 17 offshore broker/dealers whose trading was effected on the London Metal Exchange. The case is referred to as the "London Options" case. For all practical purposes, the straddle transactions, although they involved a number of variations, were basically of the *Smith/Miller* type: deductible losses were deliberately created in Year One from disposing of a straddle's loss leg, which was immediately replaced with the consequent lock-in of gain on the offsetting leg. Both legs were disposed of in Year Two with net gain approximately equal to the Year One loss. At no time was there any significant risk of loss or potential for gain from the balanced or hedged positions maintained throughout. The Court, before addressing the legal issues involved, stated: "It requires no elaborate analysis of the facts to demonstrate that the petitioners did not

[8] §1808(d) of P.L. 99-514. *See* §1881 of P.L. 99-514.

[9] H.R. Rep. No. 426, 99th Cong., 2d Sess. at 911 (1985) ("House Report").

[10] *See* H.R. Rep. No. 841, 99th Cong., 2d Sess. at II-845 (1986) ("Conference Report").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

enter into these transactions primarily for economic profit and that the transactions under scrutiny were not a type of tax motivated transaction which Congress intended to encourage. . . . The expected tax benefits completely overwhelm any potential economic benefits that might have been expected from the straddles."

The Court then examined the legislative history of the amendments to §108. It noted the Conference Committee's dropping of the House Report's language relating to the overruling of *Miller* and the intent to require the same standards as those applied under §165(c)(2). It also noted difficult to reconcile statements by Rep. Rostenkowski on the one hand and a colloquy between Senators Dole and Packwood on the other regarding the Conference Report's omission of this language. It would appear that, finding the legislative history troublesome on this point, the court decided to base its decision on what it considered to be a significant change in the flush language of §108(a) as amended, quoted above.

After a review of the cases involving "sham transactions," the court distinguished those involving "shams in fact," such as those discussed above, and those involving "shams in substance." The court first noted that the tax objective of the straddles involved in *Glass* was to "move" income from Year One of the straddle scheme to a subsequent year and in the process convert it from ordinary income to capital gain.[11] The question posed, according to the court, was whether the intentional loss generating closing transactions in Year One of these schemes "fit within what §§165 and 1234 and new §108(a) intended." The court stated that, in the words of *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), "[t]he question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." The court concluded that this question must be answered in the negative and accordingly denied the claimed losses.

The court noted that the only possibility for gain from a straddle is the "difference gain," that is, the convergence or divergence of the difference in the prices for the different delivery months involved. It then reasoned that this could not in any way be affected by the closing out and simultaneous replacement in Year One of one or more straddle positions. In other words, these transactions, viewed alone, had absolutely no profit motivation and, therefore, were sham transactions in substance. Thus, the Year One losses were not allowable.

The wording of amended §108(a), which the court earlier had noted eliminated "the concept of a 'position' as part of a transaction entered into for profit," thus disallows the loss unless it is "incurred in a transaction entered into for profit," and the motives for the *disposition of a given straddle position* may thus be considered without going into the question of whether there was a reasonable expectation of profit from *entering into the straddle transaction*, that is, the position disposed of and the other positions making up the straddle. The obscurity of the legislative history regarding whether or not Congress intended to change the meaning of "entered into for profit" was thus finessed by reliance on the amended language of §108(a).

Consistent with its disallowance of the Year One losses, the court also held that gains realized in Year Two must also be regarded as resulting from sham transactions, and must, accordingly, be disregarded for tax purposes.

The court pointed out that its holding was not in conflict with *Wehrly v. U.S.*, 792 F.2d 878 (9th Cir. 1986), which held, in a case involving a *Smith/Miller* type of straddle transaction and the application of §108(a) prior to its amendment, that the investor needs only a "reasonable expectation" of profit in order to recognize the loss, since "[t]he absence of economic substance in the London Option Transaction negates the existence of *any* profit motive." (Emphasis supplied).

C. *Other Amendments to §108*

Section 108(a) as originally enacted contained no reference to "trade or business." It provided only that a loss from the disposition of a straddle position would be allowed if it was part of a transaction entered into for profit. Subsection (b) then provided that a position held by a commodities dealer (defined by subsection (f) as having the same meaning given to such term by §1402(i)(2)(B)) or any person regularly engaged in investing in regulated futures contracts (defined by subsection (g) as having the same meaning given the term by §1256(b) as in effect prior to the enactment of P.L. 98-369) "shall be rebuttably presumed to be part of a transaction entered into for profit." In amending §108 by Act §1808(d)(2), Congress struck out subsection (b) and inserted a new subsection (b) eliminating any reference to a presumption and providing simply that for purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business. As amended, §108(f) defines the term "commodities dealer" as any taxpayer who —

> (1) At any time before January 1, 1982, was an individual described in §1402(i)(2)(B) (as added by the 1984 TRA), or
>
> (2) Was a member of the family (within the meaning of §704(e)(3) of the 1954 Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of—
>
> > (A) One or more individuals described in paragraph (1), and
> >
> > (B) One or members of the families (as so defined) of such individuals.

Under §108(h) prior to amendment, the rebuttable presumption of §108(b) did not apply to any "syndicate" as defined by §1256(e)(3)(B). Under the amended §108, sub-

[11] Many of these straddles were entered into in 1975 and 1976 at which time, prior to the effective date of §1234(b) as amended by the 1976 TRA, gain or loss from a closing transaction entered into by the grantor of an option was ordinary income or loss. Many of the straddles involved options, and the transactions were handled in such a way that the Year One loss, geared to the amount of ordinary income it was desired to offset, was generated by the closing out of an option granted by the taxpayer. At the same time, in order not to leave the taxpayer exposed to risk with respect to the other leg of the option straddle, the gain leg, usually a purchased option, would be sold generating short-term capital gain, and this gain was deferred to Year Two by the usual futures straddle technique.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

section (h) provides that any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of §1256(e)(3)(B)) is not considered a loss incurred in a trade or business.

The Conference Committee's comments on the §108 amendments omits, as already noted, any discussion of the changes made to §108(a) as they may affect a taxpayer situated similarly to the taxpayers in *Smith* and *Miller*. The Report states that the Conference agreement follows the House bill. Commenting on §108(b), it states that generally a taxpayer engaged in investment banking who regularly trades in commodities as a part of that business would be considered in the trade or business of trading commodities. Further, the report states that §108(b) applies to any position disposed of by a commodities dealer without regard to whether the position was in a commodity regularly traded by the person, whether it was traded on an exchange of which the dealer was a member, or whether an identical position was re-established on the same trading day or subsequently. The report clarifies that anyone owning a seat on a commodities exchange will be regarded as a "commodities dealer." [12]

The Conference Report, at p. II-845, also states that if a securities trading firm also regularly trades commodities in connection with its business, such trading will be treated as part of its trade or business. This rule applies only to the firm itself: it does not apply to the separate individual trading of its partners, principals, or employees, nor to partnerships or other organizations formed for the principal purpose of marketing tax straddles. *Id.*

The Report clarifies that §108(b) treatment is available not only with respect to losses incurred directly by a dealer, but also to a loss incurred by a commodities dealer in determining such person's income from an S corporation, partnership or trust. *Id.* Thus, if a dealer is a shareholder of an S corporation which incurs a commodity trading loss, the dealer is allowed the loss under §108(b). However, merely because a person is a shareholder in an S corporation, a partner in a partnership, or the holder of an interest in a trust engaged in trading commodities does not automatically bestow dealer status on that person. *Id.*

Finally, the report expresses the conferees' intent that the IRS bring all outstanding pre-ERTA straddle litigation to a "speedy resolution." *Id.*

In *King v. Comr.*, 87 T.C. No. 70 (December 2, 1986), the petitioner was a registered member of the Chicago Mercantile Exchange (CME) and its division, the International Monetary Market (IMM), and since 1950 had regularly traded commodities and RFC's and derived most of his income from such trading. In 1980 and 1981, the petitioner, through the IMM, entered into and disposed of a number of straddles involving positions in gold, incurring substantial losses. In view of the amendments to §108 outlined immediately above, the court held that the petitioner was entitled to summary judgment since (1) the IRS conceded that the petitioner was a "commodities dealer," within the meaning of §108(b) and (2) the IRS in its response alleged no facts from which it could be inferred that the transactions were shams in fact in view of the fact that all trades were carried out through a regulated exchange and pursuant to the rules thereof. In view of the 1986 amendments to §108, no issue existed as to whether the transactions in question were entered into for profit — it was sufficient that the losses were sustained on transactions effected by a commodities dealer.

Note: In *Glass*, *supra*, the court noted that at least some of the transactions there involved might involve shams in fact (*See Forseth* and *Martino*, *supra*) where prices were rigged in interdealer trades to correspond with desired tax consequences and were not subject to open outcry in the trading ring. However, the court stated that in view of its holding that the transactions there involved were shams in substance, it need not inquire into the sham in fact aspects of the case. In *King*, in view of the petitioner's dealer status, sham in fact would be the only ground for disallowing the losses there involved. However, since the pleadings showed that all trades had been effected on the exchange, there was clearly no material question of fact as to this issue. That the petitioner was a dealer and that he carried out the transactions on a regulated exchange were sufficient to entitle him to summary judgment.

V. Other Technical Corrections of the 1984 TRA Straddle Provisions

A. Coordination of S Corporation Election and Election Under 1984 TRA §102(g) and (h)

The 1984 TRA extended the mark to market and 60/40% long-term/short-term capital gains treatment, which formerly applied only to regulated futures contracts, to all "§1256 contracts," which include "dealer equity options," *i.e.*, stock options purchased or granted by an options dealer in the course of his business. These changes applied, generally, to positions established after July 18, 1984. Section 102(g) of the 1984 Act granted options dealers an election to apply mark to market and 60/40 treatment to positions established prior to the July 18 effective date and carried into taxable years which included the date of enactment of the 1984 Act, and Act §102(h) provided for installment payment of any additional taxes incurred pursuant to the election made under subsection (g). Also, §102(d) of the 1984 Act permitted qualified incorporated commodities dealers and options dealers to elect S corporation status without regard to the general requirement that such election must be made by the 15th day of the third month of the electing corporation's taxable year for which effective. There arose the question of how an S corporation election and the election under Act §102(g) and (h) were to be coordinated. Section 1808(a) of the 1986 Act: (1) adds a subsection (j) to 1984 Act §102, directing the Secretary to issue regulations as necessary to coordinate these elections; and (2) amends §102(d)(3) to allow regulatory flexibility as to the day for making the S election. These changes are effective as if enacted by the 1984 TRA. *See* 1986 TRA, §1881.

B. Amendment to §263(g)

Section 263(g) was enacted by ERTA primarily to deal with abuses involving so-called "cash and carry" straddles

[12] Conference Report at II-845.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

made up of a short commodity futures position and a long position in the commodity itself, usually a precious metal. Absent the requirement of §263(g) for capitalizing interest and carrying charges allocable to personal property making up a part of a straddle, the taxpayer could currently deduct such charges as an offset to ordinary income and, when the short position was closed out by delivery of the commodity, recoup these same expenses as long-term capital gains. Allowed as offsets to the charges required to be capitalized are certain amounts includible in gross income, such as interest, OID and market discount, and dividends. *See* §263(g)(2). If the owner of securities which constitute personal property which is part of a straddle (*e.g.*, stock held by the grantor of a covered call) pays interest on indebtedness incurred to purchase or carry the securities, or carrying charges with respect to the securities, such interest or carrying charges must be capitalized under §263(g)(1). In the case of a short sale of stock, the lender of stock which is part of a straddle (a transaction which will involve broker-dealers almost exclusively) may receive payments from the borrower in lieu of dividends or interest. The 1986 Act, §1808(b), amends §263(g)(2) to add to the list of items of income which offset the amounts which must be capitalized "any amount which is a payment with respect to a security loan (within the meaning of §512(a)(5)) includible in gross income with respect to such property for the taxable year." Thus, such lender, while required to capitalize interest and carrying charges allocable to the stock, may reduce these amounts by payments received in lieu of dividends or interest (or as other compensation) if such amounts are includible in his gross income.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 27

REVISED RULES FOR ALLOCATION OF PURCHASE PRICE IN ASSET ACQUISITIONS

Robert E. Liles, II, Esq.
Silverstein and Mullens
Washington, D.C.

I. Overview

Section 641 of the 1986 Tax Reform Act revised the rules for allocating the purchase price of a business to the assets by requiring the use of the residual method of valuation by both the transferor and transferee of the assets. The provision applies to all acquisitions of assets after May 6, 1986, with the exception of acquisitions pursuant to a binding contract in effect on such date and all times thereafter.

II. Detailed Analysis

A. Residual Method

Prior to the 1986 Tax Reform Act, the sale price from the sale of a business was allocated among the assets under one of three methods. The method generally thought to be the most accurate was the negotiation method, whereby sellers and buyers with adverse interests in the relative amounts of purchase price allocated to each asset were allowed to make a binding allocation by contract. Such negotiated allocations are in most circuits not overturned unless there is "strong proof" that the allocation did not reflect the parties' intent.[1] In the Third and Federal Circuits, stronger proof (equal to that sufficient to prove unenforceability due to mistake, undue influence, fraud, or duress) is required.[2] This method was generally accepted by the Internal Revenue Service.[3]

Another method of allocating purchase price involved determining the fair market values of each asset of the business (including intangibles) and allocating purchase price proportionally among the assets.[4] Where the fair market value of intangibles (particularly goodwill and other nonamortizable intangibles) could be accurately determined, the Service endorsed this method, even though it could result in a so-called "second tier" allocation of basis to assets in excess of their fair market value.[5]

The third method is the residual method of allocation. Under the residual method, purchase price is first allocated to cash, accounts receivable and other tangible or intangible assets up to their aggregate fair market value. Any remaining amount of purchase price is allocated to goodwill and other nonamortizable intangibles.[6] The residual method has gained favor with the Tax Court on the theory that it is a less subjective method of valuing goodwill and other nonamortizable intangibles.[7] The method has been criticized, though, by the Third Circuit as not properly reflecting goodwill and going concern value if there is either a premium or bargain element associated with the lump sum purchase.[8] The Third Circuit observed that if a premium is paid, goodwill will be inflated, and if a bargain element exists, goodwill will be understated.

Prop. Regs. §1.338(b)-2T adopts this residual method for §338 transactions. The proposed regulation establishes four asset classes (I, II, III, IV) and requires allocation of purchase price to each in order:

Class I. Cash, demand deposits, and similar accounts in banks savings and Loan associations (and other similar depository institutions).

Class II. Certificates of deposit, U.S. Government Securities, readily marketable stock or securities and foreign currency.

Class III. All assets, both tangible and intangible, (other than Class I, II, or IV assets.

Class IV. Intangible assets in the nature of goodwill and going concern value.

---

[1] *Harvey Radio Laboratories, Inc. v. Comr.*, 470 R.2d 118 (1st Cir. 1972); *Ullman v. Comr.*, 264 F.2d 305 (2d Cir. 1959); *Balthrope v. Comr.*, 356 F.2d 28 (5th Cir. 1966); *Bennett v. Comr.*, 29 T.C.M. 1230 (1970), aff'd *per curiam*, 450 F.2d 959 (6th Cir. 1971); *Schultz v. Comr.*, 294 F.2d 52 (9th Cir. 1961); *Hamlin's Trust v. Comr.*, 209 F.2d 761 (10th Cir. 1954).

[2] *Comr. v. Danielson*, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967); *Proulx v. United States*, 594 F.2d 832 (Ct. Cl. 1979).

[3] *See* S. Rep. No. 313, 99th Cong., 2d Sess. 251 (May 29, 1986) ("Senate Finance Report").

[4] *See* Regs. §1.167(a)-5; *VGS Corporation v. Comr.*, 68 T.C. 563 (1977), *acq.*, 1979-1 C.B. 1; *Banc One Corporation v. Comr.*, 84 T.C. 476, 495 (1985), and the cases cited therein. In *Banc One*, the court observed that a specific allocation in a purchase agreement or in negotiations is the best evidence of the amount to be allocated to each asset. When such evidence is not available, however, the taxpayer must make the allocation using a relative fair market value analysis. 84 T.C. at 495.

[5] *See* Rev. Rul. 77-456, 1977-2 C.B. 102. Such an allocation does require accurate determination of the fair market value of each acquired asset. See *Banc One Corp., supra*, footnote 4.

[6] *Black Industries, Inc. v. Comr.*, 38 T.C.M. 242 (1979).

[7] *Banc One Corporation*, 84 T.C. at 506.

[8] *R.M. Smith, Inc. v. Comr.*, 591 F.2d 248 (3d Cir. 1979), cert. denied, 444 U.S. 828 (1979).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Any amount in excess of the amount allocated to classes I-III is allocated to Class IV. Temp. Regs. §1.338-2T(b). Section 1060(a) of the Code, as enacted by Act §641, imposes this same method on all buyers and sellers in "applicable asset acquisitions."

While the change is ostensibly designed to simplify taxation of asset acquisitions by eliminating litigation over the allocation of purchase price,[9] taxpayers should be warned that the simplification is apparently a one-way street. The Senate Finance Committee Report makes clear that "the committee does not intend to restrict in any way the ability of the Internal Revenue Service to challenge the taxpayer's determination of the fair market value of any asset by any appropriate method. For example, in certain cases it would be reasonable for the Service to make an independent showing of the value of goodwill or going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets." [10]

Note: Some practitioners believe that Congress left a loophole in the residual method requirement of §1060 by failing to cover partnership payments under §736. It is argued that by using a partnership structure to accomplish the sale transaction, there is no allocation to goodwill. *See* "Treatment of the Residual Value of Assets Under New Section 1060," 27 *Tax Mgmt. Memo* 316 (Nov. 24, 1986). The step transaction doctrine may, however, limit the utility of such an approach.

[9] *See* Senate Finance Report at 255-54.
[10] Senate Finance Report at 255.

B. Applicable Asset Acquisitions

Section 1060(c) defines an "applicable asset acquisition" as any transfer of assets constituting a trade or business where the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets. The provision thus applies to all taxable asset sales, but would not apply to nontaxable transactions such as reorganizations. In addition, the provision applies to §1031 like kind exchanges where part of the consideration gives rise to gain under §1031(b).[11]

C. Information Reporting

Section 1060(b) of the 1986 Code provides the Treasury with authority to issue regulations requiring information reporting by buyers and sellers of the amount of consideration received for assets which is allocated to goodwill or going concern value. In addition, the Treasury may require reporting on modifications to the goodwill allocation and any other information with respect to other assets transferred in the transaction.

D. Effective Date

The revised allocation rules apply generally to asset acquisitions after May 6, 1986. An exception is provided for transactions pursuant to binding contracts in effect on May 6, 1986, and at all times thereafter.[12]

[11] 1986 Code §1060(c).
[12] Act §641(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 28

MODIFICATIONS TO RECAPTURE PROVISIONS

Patrick G. Dooher, Esq.
Jane M. Eldredge, Esq.
Silverstein and Mullens
Washington, D.C.

I. Changes Affecting Depreciation Recapture

A. Background—Pre-1986 TRA Law

Section 1245(a) of the Code provides, in part, that if "section 1245 recovery property" is disposed of after December 31, 1980, previously claimed depreciation on such property must be recaptured as ordinary income but limited to the amount of gain realized on the disposition of the property. The recapture income must be recognized notwithstanding any other provision of the Code.

Section 1245(a)(5) defines "section 1245 recovery property" as any recovery property within the meaning of §168 other than the following four categories of recovery property:

(i) 19-year real property and low-income housing which is residential rental property as defined in §167(j)(2)(B);

(ii) 19-year real property and low-income housing described in §168(f)(2), *i.e.*, property used predominantly outside the U.S. ("foreign use property");

(iii) 19-year real property and low-income housing with respect to which an election to use the straight-line percentages has been made under §168(b)(3); and

(iv) low-income housing as defined in §168(c)(2)(F).

Thus, for example, commercial real estate constitutes "section 1245 recovery property" if accelerated percentages are used, since it does not fall within any of the above categories.

Recovery property fitting within one of these four categories is subject to the recapture rules of §1250. Section 1250 provides for recapture only to the extent accelerated depreciation on the property exceeds the amount of depreciation that would have been claimed using the straight-line method.

B. 1986 TRA Amendments to Section 1245

As a result of the revision of the Accelerated Cost Recovery System (ACRS) of §168 by §201 of the 1986 TRA, under which real property will generally be depreciated using straight-line rates over either 27.5 years (residential property) or 31.5 years (nonresidential real property), the 1986 TRA [1] amended Code §1245(a) to eliminate nonresidential real property as a category subject to the §1245 recapture rules.[2] Moreover, since accelerated depreciation is not available for most real property under the revised ACRS, gain on the disposition of such property will not be subject to recapture under §1250.

Observation: Another change wrought by the 1986 TRA, §§301 and 311, the elimination of favorable capital gains treatment for both corporate and noncorporate taxpayers, will have the important collateral consequence of reducing the significance of depreciation recapture. While the depreciation recapture rules will continue to recharacterize capital gain as ordinary income, that income will be subject to tax at the same rates. However, this recharacterization may still preclude the use of capital losses, which can only offset capital gains, and may result in the acceleration of installment sales gain under §453(i). The elimination of favorable capital gains treatment becomes fully effective for corporations after 1986 and for noncorporate taxpayers after 1987. Act §§301(c) and 311(c) and (d). For further discussion, *see* Chapter 2.

Note: Another 1986 TRA change that will diminish the role of the depreciation recapture provisions is the repeal of the *General Utilities* doctrine in the corporate area. Subject to some limited exceptions, gain on corporate liquidating distributions after 1986 will be recognized at the corporate level regardless of the applicability of the depreciation recapture rules. For a discussion of *General Utilities* repeal, *see* Chapter 36.

C. Effective Date

The revised ACRS is generally effective for property placed in service after 1986. For an analysis of the effective date and transition rules, *see* Chapter 4, I, E.

II. Dispositions of Certain Wetlands and Croplands

A. Analysis

Prior to the TRA 1986, gain on the sale or other disposition of converted wetlands or highly erodible crop-

[1] Act §201(d)(11).

[2] Since the 1986 TRA revision of the ACRS eliminated the term "recovery property," the definition of "section 1245 recovery property" was stricken from §1245. Act §201(d)(11)(D).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

lands was treated as a capital gain while losses were treated as ordinary losses and were fully deductible in the taxable year in which the sale or disposition occurred.

Congress was concerned about the adverse environmental impact of the conversion of wetlands and other highly erodible lands to farming uses.[3] Thus, Congress repealed the preferential tax treatment for the disposition of converted wetlands or highly erodible croplands.[4]

"Converted wetland" refers to land that is converted within the meaning of §1201(4) of the Food Security Act of 1985[5] and is held by (i) the person who converted the wetland, (ii) any other person who uses the land for farming for any period of time after conversion, or (iii) a person whose adjusted basis in the property is determined by reference to the basis of the person in whose hands the property was converted wetland.[6] In general, it is land that has been drained or filled for the purpose of making agricultural production possible if such production would not have been possible without such action. *See* H.R. 2100, §1201(2); House Report at 652.

"Highly erodible cropland" refers to highly erodible cropland within the meaning of §1201(6) of the Food Security Act of 1985[7] if at any time the taxpayer used it for farming purposes other than the grazing of animals.[8] Generally, this is land that is either classified as class IVe, VI, VII or VIII land under the Department of Agriculture's capability classification system; or land that would have an excessive average annual rate of erosion compared to the soil loss tolerance level, as determined by the Secretary of Agriculture. *See* H.R. 2100, §1201(6); House Report at 652.

1. Gain From Sale of Disposition

Under new §1257(a), the gain from the sale or disposition of a converted wetland or highly erodible cropland shall be treated as ordinary income, rather than a capital gain. The Senate and House reports explain that this change is designed to discourage conversions of the nation's wetlands and erodible lands to farming uses.[9] However, the elimination of the capital gain differential may obviate any practical deterrent based on rate of taxation of capital assets.

2. Loss Treated as Long-Term Capital Loss

Any loss recognized on the sale or disposition of a converted wetland or highly erodible cropland shall be treated as a long-term capital loss, rather than as an ordinary loss.

3. Effective Date

The TRA 1986 amendments apply to dispositions of converted wetlands or highly erodible croplands first used for farming after March 1, 1986 in taxable years ending after that date.[10]

III. Disposition of Certain Oil, Geothermal, and Mineral Properties

A. Introduction

Recapture rules have required that a portion of the gain upon the disposition of an oil, gas or geothermal or other mineral property be characterized as ordinary income. Intangible drilling costs, depreciation of personal property, and mining exploration costs are recaptured as ordinary income to the extent of the excess of the amount realized over the adjusted basis of the property if the basis had been adjusted by the amount of the expenditures which were incurred after December 31, 1975.

However, the House was concerned that the depreciation deductions which had been allowed had exceeded the actual decline in the value of the asset upon disposition. Therefore, the House stated that in these situations, capital gains treatment should not be allowed.[11]

B. Overview and Analysis

Act §413 expands and modifies the recapture provisions of §1254 to include depletion, to the extent the depletion deduction reduced the basis of the property.

1. Depletion Costs Included

Act §413 amends §1254 by subjecting depletion, intangible drilling costs and mining exploration and development costs to recapture upon disposition of the property of an interest in oil, gas, geothermal or other mineral property.

2. Disposition of Portion of Property

Code §1254(a)(2) is restated, but is substantively unchanged. In the event of the disposition of a portion of an interest in oil, gas, geothermal or other mineral property, the amount to be recaptured would be *pro rata*, based on the proportionate share of the interest disposed of in an oil, gas, geothermal or other mining property.

3. Effective Date

The amendments to §1254 apply only to the disposition of any oil, gas, geothermal or other mineral property that was placed in service after December 31, 1986 unless acquired pursuant to a binding written contract entered into before September 25, 1985. Act §413(c).

IV. Disposition of Certain Plants and Animals for which Preproductive Expenses were Deducted

A. Introduction

Preproductive period expenses are those expenses incurred prior to the disposition of the first marketable crop or yield if the subject farm property has a useful life in excess of one year. The expenses were deductible by farmers using the cash method of accounting in the taxable year in which the expenses were paid. However, farming corpo-

[3] H.R. Rep. No. 426, 99th Cong., 1st Sess. 651 (1985) (hereafter referred to as "House Report"); S. Rep. No. 313, 99th Cong., 2d Sess. 266 (1986).
[4] New §1257.
[5] 16 U.S.C. §3801(4).
[6] Act §403, creating new Code §1257(c)(1), (3).
[7] 16 U.S.C. §3801(6).
[8] Act §403, creating new §1257(c)(2).
[9] House Report at 651; Senate Report at 266.
[10] Act §403(c).
[11] House Report at 198.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

rations or partnerships with one or more corporate partners engaged in farming were not eligible to use the cash method of accounting and, therefore, were not able to currently deduct their preproductive period revenues.[12] These taxpayers are required to use an accrual method of accounting and therefore must capitalize their preproductive period expenses. *See* Chapter 7, III.

B. Overview

The TRA 1986 adopts uniform capitalization rules for taxpayers engaged in the trade or business of farming if the preproductive period is greater than two years.[13] Congress adopted uniform capitalization rules in an effort to match expenses and the related income and to correct what the House thought were distortions in allocations of economic resources.[14] However, the special rules adopted for farmers and ranchers are not the same as the uniform capitalization rules for inventory and construction costs. Corporations, partnerships, or tax shelters required to use the accrual method of accounting under §447 or §448(a)(3) are required to capitalize preproductive costs regardless of the length of the preproductive period.[15]

Capitalization of the preproductive period costs and the interest incurred prior to production is also required if the preproductive period of the crops or livestock is more than two years.[16] There is a special exception permitting the expensing of costs incurred in replanting the same type of edible plants after loss or damage to the plants in the taxpayer's hands due to freezing temperatures, disease, drought, pests or casualty.[17]

A farmer or rancher who is not required to use an accrual method of accounting under §447 or §448(a)(3) or who does not plant, cultivate, maintain or develop pistachio trees may elect to expense the preproductive expenses rather than capitalize them.[18]

C. Analysis

1. Recapture of Preproductive Expenses which Were Deducted

If a farmer or rancher elected to currently deduct all preproductive costs of plants or animals, the gain upon the disposition of the plant or animal is recaptured at the time of disposition. The gain is recaptured to the extent of prior deductions for preproduction expenses which, but for the election, would have been capitalized.[19]

2. Effect of Election to Deduct Preproductive Period Expenses on Depreciation

A taxpayer or any "related person" electing to expense his preproductive period expenses is required to use the "alternative depreciation" system[20] for all property of the taxpayer used predominantly in the farming business and placed in service during any taxable year during which the election was in effect.[21]

3. Definitions

a. A related person, for this purpose, includes the taxpayer, members of the taxpayer's family, corporations (including S corporations) or partnerships in which the taxpayer or members of his family own at least 50% of the value of the corporate stock or the partnership or a member of a parent-subsidiary controlled group of corporations as defined in Code §1563(a)(1). §263A(e)(2)(B).

b. Members of family include the taxpayer, his spouse and any of their children who have not reached 18 by the end of the taxable year. §263A(e)(2)(C).

c. *Preproductive period* means (1) in the case of a plant or animal that will have more than one crop or yield or one off-spring, the period of time from the date of acquisition to the first marketable crop or yield from the plant or animal; or 2) in the case of any other plant or animal, the period before such plant or animal is reasonably expected to be disposed of.[22] For this purpose, use by the taxpayer in a farming business of any supply produced in the business shall be treated as a disposition.

The preproductive period for certain commercially grown plants shall be based on a national average.[23]

d. *Farming business* means the trade or business of farming and specifically includes operating a nursery or sod farm, the raising or harvesting of trees bearing fruit, nuts or other crops, or ornamental trees *except* evergreen trees which are more than 6 years old at the time they are cut.[24]

4. Effective Date

These changes apply to costs incurred after December 31, 1986 in taxable years ending after that date.[25]

---

[12] Pre-1986 TRA §447.
[13] H.R. Rep. No. 514 (Conf.), 99th Cong., 2d Sess. II-304 (1986).
[14] House Report, at 625.
[15] Act §803(a) enacting §263A(d)(1)(B).
[16] New §263A(d)(1)(A).
[17] New §263A(d)(2).
[18] New §263A(d)(3).
[19] New §263(A)(e)(1).
[20] New §168(g)(2).
[21] New §263(A)(e)(2)(A).
[22] New §263(A)(e)(3)(A).
[23] New §263(A)(e)(3)(B).
[24] New §263(A)(e)(4).
[25] Act §803(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 29

PROVISIONS RELATING TO MERCHANT MARINE CAPITAL CONSTRUCTION FUNDS

John F. Lefevere, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

The Merchant Marine Act of 1936, as amended,[1] creates federal income tax incentives for the owners and lessees of U.S.-flag vessels which are operated in the foreign or domestic commerce of the United States or in U.S. fisheries. Through the Capital Construction Fund (CCF), an owner or lessee of a vessel can establish what is essentially a government-sponsored tax shelter which permits a current deduction for amounts deposited into the CCF and also an exclusion from income of the earnings from the investment or reinvestment of amounts held in the Fund.[2] The CCF Agreement is entered into between the taxpayer and either the Secretary of Transportation [3] or, in the case of fishing vessels, the Secretary of Commerce.[4]

The nature of a withdrawal from a CCF determines how it will be treated for federal income tax purposes. If the taxpayer makes a "qualified withdrawal" in order to acquire, construct, or reconstruct a "qualified vessel" [5] or for the payment of the principal on the indebtedness incurred in connection with the acquisition, construction, or reconstruction of such vessel, then the amount withdrawn is treated as first being made out of the Agreement's capital account, then out of the capital gain account and finally out of the ordinary income account.[6] However, any withdrawal which is not used for a qualified purpose is treated as a "nonqualified withdrawal," with tax treatment in the opposite order from that described above for qualified withdrawals. Nonqualified withdrawals also cause interest to be imposed for a period beginning from the date of deposit of the amount being withdrawn (as calculated under the ordering rules for nonqualified withdrawals).

In return for receiving qualified withdrawal treatment, the taxpayer must reduce the tax basis of the qualified vessel by the amount of the withdrawal.[7] No provisions governing the CCF were included in the Internal Revenue Code of 1954 and interpretation of the CCF Agreements was left largely to the respective Departments which administer the Agreements, rather than to the IRS. President Reagan, in his proposals for tax reform,[8] called for the repeal of special tax treatment for CCFs.[9] The Proposals questioned whether there was still an underlying national security reason for subsidizing the construction of U.S.-flag vessels and indicated that direct subsidy programs would be a preferable method of achieving the support of naval defense functions.

II. Overview

Led by the House Ways and Means Committee, Congress rejected the President's proposed repeal of the CCF and instead strengthened its provisions. The Tax Reform Act of 1986 incorporated the tax provisions contained in the Merchant Marine Act of 1936 in §7518 of the Internal Revenue Code of 1986. The 1986 Act also imposed the maximum marginal rate of tax on nonqualified withdrawals made after December 31, 1986, in addition to the interest already imposed. Moreover, a 25 year limit was imposed on the amount of time monies can remain in a CCF without being withdrawn for qualified purposes. At the end of this period, 20% of the funds are treated as having been withdrawn as a nonqualified withdrawal in the 26th year, and an additional 20% is treated as withdrawn in each subsequent year until, at the end of the 30th year, 100% of the funds are deemed withdrawn as a nonqualified withdrawal.

The term "qualified withdrawal" is to be interpreted as including the purchase or lease of an "agreement vessel" (*i.e.*, a vessel subject to a CCF agreement) for a period of five years or more.

Finally, both the Secretary of Transportation and the Secretary of Commerce are required to certify to the Secretary of the Treasury that the amount of funds held in the CCF are appropriate for the vessel construction pro-

[1] 46 U.S.C. §1101 *et seq.*

[2] 46 U.S.C. §1177 (commonly referred to as §607 of the Merchant Marine Act of 1936, as amended).

[3] The Maritime Administration, formerly part of the Department of Commerce, is the agency directly involved in administration of the CCF.

[4] The National Oceanic and Atmospheric Administration (NOAA), U.S. Department of Commerce, is the administrative agency for fishing vessel CCFs.

[5] A "qualified vessel" is one which is constructed or reconstructed in the United States, documented under the laws of the United States, and operated in the United States, foreign, Great Lakes, or noncontiguous domestic trade (or, in the case of fishing vessels, in the fisheries of the United States). 46 U.S.C. §1177(k)(2). The concept includes those barges and containers which are carried aboard such vessels.

[6] 46 U.S.C. §1177(g)(1).

[7] 46 U.S.C. §1177(g)(3) and (4). The basis is reduced to the extent of any qualified withdrawal made from the ordinary income account. If the withdrawal is made from the capital gain account, in the case of a corporation (other than an S corporation), the basis reduction is five-eighths of the qualified withdrawal amount, while for any other person, the basis reduction is one-half of the qualified withdrawal amount.

[8] The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985).

[9] *Id.* at 304-306.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

gram contemplated by the CCF Agreement. Should it develop that the current funds exceed the needs of the taxpayer's program, the fundholder will be given three years to develop appropriate program objectives. Failure to meet the three year deadline will result in the excess funds being treated as a nonqualified withdrawal.

All amendments relating to the Capital Construction Fund apply to taxable years beginning after December 31, 1986.[10]

III. Detailed Analysis

A. Coordination of Merchant Marine Act and Internal Revenue Code

The tax provisions contained in §1177 of Title 46 U.S.C. are codified as §7518 of the Internal Revenue Code of 1986,[11] specifically, the Merchant Marine Act provisions relating to the ceiling on deposits,[12] the requirements as to investments,[13] nontaxability of deposits,[14] establishment of accounts,[15] the purposes of qualified withdrawals,[16] the tax treatment of qualified withdrawals,[17] the tax treatment of nonqualified withdrawals,[18] and the treatment of certain corporate reorganizations and changes in partnerships.[19] Moreover, the definitions of §1177(k) (§607(k) of the Merchant Marine Act of 1936) are incorporated by reference by Code §7518(i).

Code provisions are also added to treat amounts not withdrawn after 25 years in the CCF as nonqualified withdrawals,[20] and to tax nonqualified withdrawals at the highest marginal tax rate.[21]

Incorporation of the Merchant Marine Act CCF provisions into the Internal Revenue Code of 1986 may raise jurisdictional problems in Congress when further amendment of the CCF program is sought. The House Report contains an exchange of correspondence between House Ways and Means Committee Chairman Dan Rostenkowski and House Merchant Marine and Fisheries Chairman Walter B. Jones expressing the expectation that there would be future cooperation between the two committees when amendments to either §1177 of the Merchant Marine Act or Code §7518 are considered.[22] Each committee chairman noted that the Merchant Marine and Fisheries Committee had cooperated in creating the legislation without prejudicing the committee's jurisdictional rights under §1(n) of House Rule X. That Rule provides that the House Committee on Merchant Marine and Fisheries as a standing committee has jurisdiction over the merchant marine generally.[23]

B. Definition of "Qualified Withdrawals"

As defined in Code §7518(e), the term "qualified withdrawal" is a withdrawal made only for: (1) the acquisition, construction, or reconstruction of a qualified vessel (or barge or container which is a part of the complement of a qualified vessel); or (2) for the payment of the principal on indebtedness incurred in connection with the acquisition, construction, or reconstruction of such an item. However, in language included in the House Report and presumably adopted in conference, the leasing of certain agreement vessels is included for the first time. Thus, the phrase "acquisition, construction, or reconstruction" will be interpreted to include an acquisition through either the purchase or lease of an agreement vessel for a period of five years or more.[24] This interpretation is intended to reflect the current maritime industry practice of vessel acquisition through lease rather than purchase.[25] It also parallels both the scope of eligibility for establishing a CCF and of qualified withdrawals through a down payment on the purchase price or the payment of long-term indebtedness on a vessel.[26]

C. Tax Treatment of Nonqualified Withdrawals

The ordering rules for nonqualified withdrawals are retained in the codification of the CCF rules. However, in addition to the imposition of interest from the date the withdrawal is reported, Code §7518(g)(6) requires that in any taxable year in which a nonqualified withdrawal is made, the withdrawal is taxed at the highest marginal rate applicable to an individual (not exceeding 28 %) or a corporation (not exceeding 34%).[27] This is accomplished by excluding the nonqualified withdrawal from gross income and increasing the Chapter 1 tax by the product of the amount of the nonqualified withdrawal and the highest rate of tax specified in §1 (for individuals) or §11 (for corporations).[28]

A tax benefit rule is also set up so that if any portion of a nonqualified withdrawal is attributable to deposits (other than earnings on deposits) that did not reduce the taxpayer's tax liability in a year prior to withdrawal, it is not taken into account when calculating the tax at the highest marginal rate, and is treated as allowed as a deduction under §172 for the year of withdrawal.[29] Moreover, any nonqualified withdrawal which is excluded from gross income for purposes of calculating the highest marginal rate of taxation is also excluded from the determination of taxable income when calculating the net operating loss carryover and carryback under §172(b)(2).[30]

D. Twenty-Five Year Limit on Fund Deposits

In an effort to discourage fundholders from permitting monies to remain tax-exempt for extended periods of time

[10] Tax Reform Act of 1986, P.L. 99-514, §261(g) ("Act").
[11] Act §261(b).
[12] Merchant Marine Act of 1936 (MMA) §1177(b) recodified as Code §7518(a).
[13] MMA §1177(c); Code §7518(b).
[14] MMA §1177(d); Code §7518(c).
[15] MMA §1177(e); Code §7518(d).
[16] MMA §1177(f); Code §1177(e).
[17] MMA §1177(g); Code §7518(f).
[18] MMA §1177(h); Code §7518(g).
[19] MMA §1177(i); Code §7518(h).
[20] Code §7518(g)(5).
[21] Code §7518(g)(6).
[22] H.R. Rep. No. 426, 99th Cong., 1st Sess. 193-194 (1985) ("House Report").
[23] *See* Rule X, §1(n)(1), Rules of the House of Representatives, H. Doc. 277, 98th Cong., 2d Sess. 371 (1985).
[24] House Report at 191.
[25] *Id.* at 192.
[26] *Id.*
[27] Code §7518(g)(6)(A).
[28] Code §7518(g)(6)(A)(i) and (ii).
[29] Code §7518(g)(6)(B). *See also* House Report at 192.
[30] Code §7518(g)(6)(C).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

in a CCF without withdrawal for qualified purposes, the 1986 Act imposes a 25 year limit on such holdings.[31] The 25 year period begins to run on January 1, 1987, the date on which all monies previously deposited in a CCF are deemed to have been deposited.[32] If any amounts remain in the CCF after 25 years, specific percentages are treated as nonqualified withdrawals in each of five years.[33] The percentages are 20% (in the 26th year), 40% (27th year), 60% (28th year), 80% (29th year) and 100% in the 30th year.[34]

The Secretary of the Treasury is empowered to determine whether the amounts in a CCF exceed the amounts which are appropriate to meet the vessel construction program objectives of the Agreement.[35] The Secretary can make this determination from written reports which are to be submitted to him within 120 days of the close of the taxable year under an amendment to the Merchant Marine Act.[36] If an excess exists, that amount will be treated as a nonqualified withdrawal unless the fundholder develops appropriate program objectives within three years in order to dissipate the excess.[37]

[31] Act §261(b) enacting Code §7518(g)(5). This is much longer than the 10-year period proposed by the House. *See* House Report at 192-193.
[32] Code §7518(g)(5)(E).
[33] Code §7518(g)(5)(A).
[34] *Id.*
[35] Code §7815(g)(5)(D).
[36] Act §261(d) adding subsection (m) to §1177 of the Merchant Marine Act of 1936.
[37] Code §7518(g)(5)(D).

E. Other Amendments

1. Exception to Definition of Tax Liability under §26(b)

As enacted by the Tax Reform Act of 1984, Code §26 provides a uniform limitation on the application of nonrefundable personal credits against tax by stating that the sum of the nonrefundable personal credits for a taxable year shall not exceed the taxpayer's liability for such year. The term "tax liability" is defined in §26(b) as the tax imposed under Chapter 1 (the income tax provisions) for the taxable year, except for eight specific taxes. The Tax Reform Act of 1986 adds, as a ninth category, the tax imposed at the taxpayer's highest marginal rate under Code §7518(g)(6)(A).[38]

2. Conformity with Merchant Marine Act of 1936

In keeping with the parallel changes made between the Merchant Marine Act of 1936 and the Internal Revenue Code of 1986,[39] conforming amendments were made to the Merchant Marine Act to cross-reference to Code §7518.[40] In addition, provisions identical to Code §7518(g)(5) and (6) were added to the Merchant Marine Act.[41]

[38] Act §261(c) adding subparagraph (I) at the end of §26(b)(2).
[39] *See* House Report at 193 (Letter to Chairman Rostenkowski from Chairman Jones).
[40] *See* Act §261(e)(1) through (5).
[41] Act §261(e)(6), adding paragraphs (5) and (6) to MMA §1177(h).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 30

REVISION AND EXTENSION OF LIMITATIONS ON TAX-EXEMPT BONDS

Robert E. Liles, II, Esq.
Brant Baber, Esq.
Margo B. Stern, Esq.
Silverstein and Mullens
Washington, D.C.

I. Overview

Title XIII of the 1986 Tax Reform Act restructures the provisions of the Code dealing with tax exempt bonds, imposes certain new restrictions and extends many existing restrictions. Sections 103 and 103A of the 1954 Code are reorganized into 11 new sections, §103 and §§141 through 150. Section 103 of the 1986 Code is a general section conferring Federal income tax exemption on the interest on obligations of a state or political subdivision thereof, subject to certain exceptions to tax exemption for nonqualified private activity bonds, arbitrage bonds and unregistered bonds. There is no §103A under the 1986 Code.

The substantive provisions of §§141 through 150 of the 1986 Code and their corresponding provisions under the 1954 Code are as follows:

Section 141: Private activity bonds (formerly IDBs) and qualified bonds.[1]

Section 142: Exempt facility bonds.[2]

Section 143: Mortgage revenue bonds, qualified mortgage bonds and qualified veterans' mortgage bonds.[3]

Section 144: Qualified small issue, student loan and redevelopment bonds.[4]

Section 145: Qualified 501(c)(3) bonds.[5]

Section 146: Volume Cap.[6]

Section 147: Other requirements for private activity bonds.[7]

Section 148: Arbitrage.[8]

Section 149: Registration and other requirements.[9]

Section 150: Definitions and special rules.[10]

[1] 1954 Code §103(b).
[2] 1954 Code §103(b)(4).
[3] 1954 Code §103A.
[4] 1954 Code §103(b)(6), (o)(3).
[5] 1954 Code §103(b)(3).
[6] 1954 Code §103(n).
[7] 1954 Code §103(b)(13), (14), (16), (17), (18), and 103(k).
[8] 1954 Code §103(c).
[9] 1954 Code §103(j), (h), (l), (m).
[10] 1954 Code §103(a)(2), 103(i).

Certain themes recur in the 1986 Act's tightening of restrictions and extension of existing restrictions. Keeping these themes in mind should aid the reader in following the discussion below:

1. The private business use and security interest tests for determining whether a bond is a private activity bond have been generally decreased from 25% to 10%. This applies in the case of both private activity bonds and qualified §501(c)(3) bonds.

2. The percentage of so-called "bad" costs which may be paid with bond proceeds of a private activity bond is reduced from 10% to 5%. This restriction is further tightened by treating costs of issuance as "bad" costs.

3. Low and moderate income housing's preferential treatment is substantially reduced by more stringent qualifying income tests, application of the volume cap and extension of the rebate requirement.

II. Detailed Analysis

A. *Section 103*

Under the 1954 Code, all tax exempt bond rules (with the exception of the mortgage subsidy bond provisions of §103A) were contained in §103. Under the 1986 Code, §103 is the section which provides the organizational structure for the ten substantive provisions of §§141-150. 1986 Code §103(a) provides the general rule that interest on any state or local bond is not includable in gross income for Federal income tax purposes.[11] 1986 Code §103(b) provides three exceptions to the tax exemption provision: (i) private activity bonds which are not *qualified* private activity bonds;[12] (ii) arbitrage bonds,[13] and, (iii) bonds not properly registered.[14]

[11] A "state or local bond" is an obligation of a state or political subdivision thereof. 1986 Code §103(c)(1). "State" includes the District of Columbia or a United States possession. 1986 Code §103(c)(2). *Compare* §103(a)(1) of the 1954 Code (providing substantially the same rules).

[12] Qualified bonds are those listed in 1986 Code §141(d)(1). Bonds that would otherwise be qualified bonds are disqualified if the state volume cap requirements are not met (see 1986 Code §§141(d)(2) and 146) or if the bond fails any of the requirements of 1986 Code §147 (substantial user requirement, 120% maturity limit, 25% land acquisition limit, rehabilitation requirement for existing structures, skybox, etc. prohibition, public approval requirement, and restriction on issuance costs). *See* 1986 Code§ §141(d)(3) and (4).

[13] 1986 Code §103(b)(2); *see* 1986 Code §148.

[14] 1986 Code §103(b)(3); *see* 1986 Code §149(a).

B. *Private Activity Bonds*[15]

1. *Introduction*

The 1986 TRA changes the tax-exempt financing lexicon by deleting "industrial development bond" ("IDB") and substituting for it "private activity bond" ("PAB").[16] The Act tightens the qualifications for PABs. PABs are taxable unless the bond is a "qualified bond." [17] Qualified bonds are:[18] exempt facility bonds;[19] qualified mortgage bonds;[20] qualified veterans' mortgage bonds;[21] qualified small issue bonds;[22] qualified student loans bonds;[23] qualified redevelopment bonds;[24] or qualified 501(c)(3) bonds.[25]

2. *Trade or Business and Security Interest Tests*

Under the 1954 Code, bonds issued by a state or local government are IDBs if (a) all or a major portion of the bond proceeds are used directly or indirectly in the trade or business of a person other than a governmental unit or a §501(c)(3) organization,[26] and (b) the payment of principal or interest on the debt is in whole or in major part (i) secured by trade or business property or in "payments in respect of such property," or (ii) derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.[27] Regs. §1.103-7(b)(3)(iii) establishes 25% as the "major portion" for both the trade or business and security interest tests. 1986 Code §141(a) provides that a PAB includes a bond which meets both the private business use test of §141(b)(1) and the private security or payment test of §141(b)(2). 1986 Code §141(b)(1) provides that the private business use test is met if more than 10% of the proceeds [28] of an issue are to be used for a private business use. Private business use is direct or indirect use in a trade or business of a person other than a governmental unit.[29] In calculating trade or business use, the activities of all §501(c)(3) organizations, the Federal Government, and all nongovernmental persons who are not natural persons are treated as trade or business activities.[30] As under pre-1986 TRA law, use as a member of the general public is not taken into account.[31]

While all activities by a §501(c)(3) organization are included in the 10% calculation, the issuer may elect to exclude from the proceeds side of the computation (for purposes of the private business tests or the private loan financing test) that portion of the bond proceeds which could qualify as a §501(c)(3) bond [32] if such portion had been issued as a separate issue.[33]

3. *Management Contracts*

Government-owned facilities may be treated as used in private business if a private person manages the facility under a management contract which in substance transfers use of the facility to the private person. Under pre-1986 TRA law, the IRS adopted standards for ruling that a management contract did not constitute private business use.[34] Under these standards the Service would issue a favorable ruling if:

> (1) The management services were provided for a reasonable, periodic flat fee, under a contract not exceeding five years (including renewals), with the exempt owner having the option to cancel the contract without penalty at the end of any two-year period; or
>
> (2) In the case of certain newly operational facilities, compensation was based on a percentage of gross revenues from the facility for a period which generally could not exceed one year.

In one of the few instances where Congress relaxed tax exempt bond rules, the Conference Report directs Treasury to change the requirements for a favorable ruling as follows: [35]

> (1) The periodic, fixed compensation requirement is relaxed to 50% of the compensation. No compensation may be based on net profits. Thus, a management contract calling for a fixed fee plus a percentage of gross revenues (not to exceed the fixed fee) would be permissible.
>
> (2) The two-year, no-penalty termination period is extended to three years.

4. *Output Contracts*

Under Treasury regulations issued under prior law, if a nonexempt person takes a sufficiently large portion of the output of a bond-financed facility (such as electric, gas or water utilities) owned by an exempt person, *i.e.*, state and local government or §501(c)(3) organization, the issue will be deemed to satisfy the trade or business and security interest tests. 1986 Code §141 further tightens this treatment of output contracts.

Regs. §1.103-7(b)(5)(i) provides that the use by nonexempt persons of a major portion of bond-financed output facilities, such as utilities, satisfies the trade or business test and security interest test if the use has the effect of transferring to the nonexempt persons the benefits of facility ownership and the burdens of paying the debt service on the issue. Such a transfer occurs where payments made or

---

[15] 1986 Code §141.
[16] 1986 Code §141(a).
[17] 1986 Code §103(b)(1).
[18] 1986 Code §141(d).
[19] *See* 1986 Code §142.
[20] *See* 1986 Code §143(a).
[21] *See* 1986 Code §143(b).
[22] *See* 1986 Code §144(a).
[23] *See* 1986 Code §144(b).
[24] *See* 1986 Code §144(c).
[25] *See* 1986 Code §145.
[26] 1954 Code §103(b)(2)(A) and (3). This is known as the trade or business test.
[27] §103(b)(2)(B). This is known as the security interest test.
[28] For purposes of the trade or business and security interest tests, "proceeds" are determined as net of costs of issuance and reasonably required reserve or replacement fund amounts. *See* H.R. Rep. No. 841, 99th Cong., 2d Sess. II-687 n.8 ("Conference Report"). Note that this differs from the definition of "net proceeds" which excludes reasonably required reserve or replacement fund amounts but does not allow deduction for costs of issuance. 1986 Code §150(a)(3).
[29] 1986 Code §141(b)(6)(A).
[30] 1986 Code §141(b)(6); Conference Report at II-688.
[31] 1986 Code §141(b)(6)(A); *compare* Regs. §1.103-7(b)(3)(i).
[32] *See* II., F, below.
[33] 1986 Code §141(b)(9). Such an election will have the effect of applying the qualifying §501(c)(3) bond portion against the §501(c)(3) organization's $150,000,000 volume limit. *See* §145(b).
[34] Rev. Proc. 82-14, 1982-1 C.B. 459.
[35] Conference Report at II-688-9.

to be made on the output contracts described in (a) and (b) below exceed 25% of the debt service on the bonds and (a) one nonexempt person agrees to take more than 25% of the total output of the facility over the term of the bonds, or (b) two or more nonexempt persons (each making minimum payments exceeding 3% of average annual debt service) agree to take, in the aggregate, more than 25% of the output of the facility.

1986 Code §141(b)(4) creates a new trade or business and security test limit for output facilities other than water facilities: if 5% or more of the proceeds of an issue are to be used with respect to an output facility, the issue is treated as meeting the trade or business and security interest tests if the amount of bond proceeds which may be expended on the portion of the facility attributable to output contracts with nonexempt persons is the lesser of 10% or $15,000,000. *See* Conference Report at II-689-90 (*Examples).* Where prior outstanding bond issues (other than refinanced issues) have benefited the facility, the $15,000,000 amount is reduced by the portion of such prior issues attributable to output contracts with nonexempt persons. Furthermore, the 3% of annual debt service qualifying provision under the regulations will be deleted.[36]

Example: Assume that City plans to build a $300 million power facility and that nonexempt Corporation agrees to take 20% of the output of the facility. Under the pre-1986 TRA regulations and assuming that there were no other output contracts for the facility, City could build the facility with $300 million of bond proceeds and the issue would not be an IDB. Under §141(b)(5), however, the issue will be a PAB if the amount of bonds issued with respect to the facility exceeds $255 million.[37]

5. Unrelated Uses

Under the 1954 Code, where the 25% major portion threshold is not met under the trade or business and security interests tests, the issue will not be an IDB regardless of the fact that private use proceeds are expended for a use completely unrelated to the state or local government's use of the rest of the proceeds. Thus, if a city issued bonds and 85% of the proceeds were used to build a courthouse while 15% of the proceeds were used to build a private office building across town, the bond would not be an IDB because 25% or less of the proceeds were used in the trade or business of a nonexempt person.

1986 Code §141(b)(3)(A) provides that an issue is a PAB if (1) more than 5% of the proceeds of an issue are used (a) for a private business use unrelated to the governmental use of the proceeds, or (b) for a disproportionate business use, and (2) a 5% security interest test is met. The Conference Report provides that the determination of a relation (or lack thereof) between the private use and the governmental use is made on a case-by-case basis focusing on the "operational relationship" between the uses.[38] The report stresses that proximity is a significant factor in the "operational relationship." Thus, in the example above, the bond would be a PAB.

Examples: The Committee Report cites the examples of a newsstand in a courthouse or a privately operated school cafeteria as related private uses and an administrative office building for the cafeteria company or office space for lawyers (presumably within the courthouse) as unrelated private uses.

Somewhat more amorphous is the concept of disproportionate (but related) private use. A related private use is disproportionate to the extent that the bond proceeds spent on the related private use exceeds the bond proceeds spent on the governmental use to which the private use relates.[39] Multiple, related private use facilities with respect to a single governmental use are aggregated.[40] Thus, private uses which are related to different governmental uses are compared separately.

Comment: The disproportionate related private use test is only relevant where the bond issue finances more than one governmental facility since private use proceeds can in no event exceed 10% of total proceeds without the bond becoming a PAB. Thus, the test comes into play where the private use is related to a relatively small governmental portion of the bond issue. Accordingly, the test will most often apply where a governmental use is added to a bond issue in order to provide a related use for a private use.

6. Private Loan Bonds

Under both the 1954 and 1986 Codes, private loan bonds are also treated as IDB/PABs. However, the 1954 Code definition is tightened.

Section 103(o)(1) of the 1954 Code provides that interest on consumer loan bonds is includable in gross income. Consumer loan bonds are obligations issued as part of an issue all or a significant portion (5% - *See* House Report at 493-494) of the proceeds of which are reasonably expected to be used to make loans to nonexempt persons. Exceptions are provided for exempt IDBs, qualified mortgage subsidy bonds, qualified veterans' mortgage bonds and qualified student loan bonds.[41] Additional "excluded loans" are excepted from the definition.[42]

Section 141(a)(2) of the 1986 Code provides that bonds meeting the private loan financing test are PABs. The private loan financing test is met if the proceeds of the issue used directly or indirectly to make or finance loans to persons other than governmental units exceed the lesser of 5% of such proceeds or $5,000,000.[43] Tax assessment loans and investments in nonpurpose obligations are excepted.[44]

7. Effective Date

The revised requirements for PABs apply to bonds issued after August 15, 1986.[45] Exceptions are provided for

[36] Conference Report at II-689 n.12.
[37] $300 million multiplied by 80%, plus $15 million. *See* Conference Report at II-690, *Example 1.*
[38] Conference Report at II-691.
[39] 1986 Code §141(b)(3)(B).
[40] Conference Report at II-691.
[41] 1954 Code §103(o)(2)(B).
[42] 1954 Code §103(o)(2)(C).
[43] 1986 Code §141(c)(1).
[44] 1986 Code §141(c)(2).
[45] 1986 TRA §1311(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

certain binding contracts and refundings of bonds issued before August 16, 1986.[46]

C. *Exempt Facility Bonds*

1. *Introduction*

An exempt facility bond ("EFB") is a PAB that is tax exempt by reason of §142 of the 1986 Code. EFBs are generally the IDBs which qualified for tax exemption under §103(b)(4) of the 1954 Code, except that the following bonds exempt for certain facilities under the 1954 Code are no longer exempt:

- Sport facilities [47]
- Convention or trade show facilities [48]
- Parking facilities [49]
- Hydroelectric generating facilities [50]
- Air or water pollution control facilities [51]
- Industrial parks [52]
- Mass Commuting vehicles [53]

The 1986 Code includes one exempt facility not in the 1954 Code (qualified hazardous waste facilities) [54] and continues the exemption for the following facilities (subject to certain additional restrictions discussed *infra*):

- Airports [55]
- Docks and wharves [56]
- Mass commuting facilities [57]
- Facilities for the furnishing of water [58]
- Sewage facilities [59]
- Solid waste disposal facilities [60]
- Qualified residential rental projects [61]
- Facilities for the local furnishing of electric energy or gas [62]
- Local district heating or cooling facilities [63]

2. *Use of Proceeds*

Under §103(b)(4) of the 1954 Code, substantially all of the proceeds of an exempt facility IDB must be used to provide the exempt facility. Regs. §1.103-8(a) defines "substantially all" as 90% of the proceeds. "Proceeds" are determined net of costs of issuance (costs of issuance are thus considered "neutral" costs rather than qualifying ("good") or nonqualifying ("bad") costs)). Costs of issuance include bond election costs, costs of publishing notices, attorney's fees, printing costs, trustees fees for fiscal agents and similar expenses including underwriter's discount.[64] Amounts used to provide an exempt facility include amounts paid or incurred which are chargeable to the facility's capital account or would be so chargeable either with a proper election (as under Code §266) or but for an election to deduct such amounts.[65]

Section 142(a) of the 1986 Code requires that 95% of the "net proceeds" of the issue be spent for the exempt facility. Net proceeds are defined as proceeds less amounts invested in a reasonably required reserve or replacement fund ("4R Fund").[66] Therefore, costs of issuance are not part of the reduction to net proceeds and are thus treated as "bad" costs. *See* Conference Report at II-697.

3. *Low and Moderate Income Housing*

The 1986 Code substantially tightens the restrictions on EFBs issued to provide low and moderate income housing (called "qualified residential rental project"). Under 1954 Code §103(b)(4)(A), residential rental projects qualify for tax-exempt IDB financing if throughout the project period 20% of the units (15% in targeted area projects) are to be occupied by individuals of "low and moderate income." Residential rental projects are one or more proximate buildings containing one or more similarly constructed units which are used on other than a transient basis.[67] Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, nursing homes, sanitariums, rest homes, and trailer parks for use on a transient basis are not residential rental projects.[68] The low and moderate income determination is required to be made in a manner consistent with determinations of lower income families under §8 of the United States Housing Act of 1937, except that the percentage of median gross income which qualifies as low and moderate income is 80%.[69] Thus, a tenant meets the low and moderate income requirements if the aggregate income of all persons living in the unit does not exceed 80% of the median gross income for the area. Regulations with respect to adjustment of the incomes of tenants by family size under §103(b)(4)(A) of the 1954 Code were proposed by the Treasury Department and published in The Federal Register on November 7, 1985, to be effective for residential rental projects financed with the proceeds of tax-exempt bonds issued on or after January 1, 1986.[70] Under these proposed regulations, the 80% of median gross income limitation is deemed to apply to a family of four. For tenants with smaller size families, the percentage is reduced and for families of larger sizes the percentage is increased. The percentages of area median gross income ("AMGI") by family size are:

---

[46] 1986 TRA §§1312(a) and 1313(a)(1).
[47] 1954 Code §103(b)(4)(B).
[48] 1954 Code §103(b)(4)(C).
[49] 1954 Code §103(b)(4)(D).
[50] 1954 Code §103(b)(4)(H).
[51] 1954 Code §103(b)(4)(F).
[52] 1954 Code §103(b)(5).
[53] 1954 Code §103 (b)(4)(I).
[54] 1986 Code §142(a)(10).
[55] 1986 Code §142(a)(1); 1954 Code §103(b)(4)(D).
[56] 1986 Code §142(a)(2); 1954 Code §103(b)(4)(D).
[57] 1986 Code §142(a)(3); 1954 Code §103(b)(4)(D).
[58] 1986 Code §142(a)(4); 1954 Code §103(b)(4)(G).
[59] 1986 Code §142(a)(5); 1954 Code §103(b)(4)(E).
[60] 1986 Code §142(a)(6); 1954 Code §103(b)(4)(E).
[61] 1986 Code §142(a)(7); 1954 Code §103(b)(4)(A).
[62] 1986 Code §142(a)(8); 1954 Code §103(b)(4)(E).
[63] 1986 Code §142(a)(9); 1954 Code §103(b)(4)(J).
[64] Rev. Rul. 79-332, 1979-2 C.B. 38.
[65] Regs. §1.103-8(a)(1).
[66] 1986 Code §150(a)(3); Conference Report at II-697.
[67] Regs. §103-8(b)(4).
[68] Regs. §1.103-8(b)(4)(i).
[69] Regs. §1.103-8(b)(8)(v).
[70] Prop. Regs. §1.103-8(b)(8).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Family Size	% of AMGI
8 or more	100%
7	95%
6	90%
5	85%
4	80%
3	72%
2	64%
1	56%

Amounts are rounded to the nearest increment of $50.

Example: Assume that a low and moderate housing project contains studio and one bedroom apartments which will be rented to persons of low and moderate income. The studio apartments are suitable for one person, the one bedroom apartments for two. If AMGI is $25,000, the studio apartments may be rented to persons with incomes of up to $14,000 and the one bedrooms may be rented to two person families with incomes of up to $16,000.

The qualified project period during which the income limitations apply under the 1954 Code is a period beginning on the date at least 10% of the units in the project are first occupied and ending on the latest of (a) ten years after the date on which 50% of the units are first occupied; (b) 50% of the term of the bond with the longest maturity in the issue; or (c) the date on which assistance under §8 of the United States Housing Act of 1937 terminates.[71]

Under the 1986 Code the low and moderate income test essentially becomes a low income test.[72] The 80% of AMGI is reduced to 50% of AMGI.[73] In order for a project to qualify, not less than 20% of the units must be occupied by persons with 50% or less of the AMGI. Alternatively, the issuer may elect at the time of issuance to opt for a 40-60 test, renting 40% of the units to persons with 60% of AMGI.[74]

Comment: The election is cast in terms of an issuer's election. The choice is obviously most critical to the developer since it is the developer who must live with the economic restraints. Accordingly, the bond documents should contain provisions by which the developer directs the issuer's choice of tests.

The family size adjustment provisions also apply to the AMGI percentages.[75] Thus the percentages of AMGI applicable to §142(d) qualified residential rental projects are as follows:

Family Size	50% Test % of AMGI	60% Test % of AMGI
8 or more	66%	80%
7	62%	75%
6	58%	70%
5	54%	65%
4	50%	60%
3	45%	54%
2	40%	48%
1	35%	42%

Example: Assuming that the housing project in the example above is subject to the 1986 Code income limits and the AMGI remains at $25,000, the income limit for two person families is $10,000 under the 50% test and $12,000 under the 60% test. Both of these numbers are less than the income of two people working full time at minimum wage. The income limit for 1 person units is $8750 under the 50% test and $10,500 under the 60% test.

Observation: Even in areas with relatively high AMGI, it is difficult to see how the operation of both the low income limits and the family size adjustments can produce a result that is economically feasible to the developer, in the absence of a rent-subsidy program. If AMGI is a relatively high $32,000, the single person income limit under the 50% test is $11,200. Using the rule of thumb that a person's housing cost should not exceed 30% of income, the tenant should not pay much more than $280 per month for a studio apartment. In such relatively high cost areas, it is doubtful that such rent is economically feasible. Such examples suggest that the practical intent of the new low income limits and family size adjustments is to end tax-exempt financing of residential rental housing.

The difficulty of using an EFB to finance residential rental housing is further complicated by the extension of the qualified project period to the latest of (1) 15 years after the date on which 50% of the units in the project are occupied, (2) the date on which no bonds are outstanding or (3) the date on which assistance under §8 of the United States Housing Act of 1937 terminates.[76] The qualified project period has been essentially extended by 50% (from 10 years to 15 years after the date on which 50% of the units are occupied).

Under the 1954 Code, initially qualifying low and moderate income tenants continued to be qualified tenants for their unit notwithstanding that the tenants' income subsequently increased beyond the income limit during their tenancy.[77] Under the 1986 Code, low income tenants with increasing incomes continue to be treated as qualifying tenants until such time as their incomes exceed 140% of the applicable income limit.[78] The determination of a tenant's qualification under the low income test must be made annually, based on current income.[79]

[71] Regs. §1.103-8(b)(7).
[72] Indeed, in HUD parlance, the test goes from a low income (80%) test to a *very* low income (50%) test. *See* 24 CFR §813.102.
[73] 1986 Code §142(d)(1)(A).
[74] 1986 Code §142(d)(1)(B).
[75] 1986 Code §142(d)(2)(B).
[76] 1986 Code §142(d)(2)(A).
[77] Regs. §1.103-8(b)(5)(ii).
[78] 1986 Code §142(d)(3)(B).
[79] 1986 Code §142(d)(3)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Example: Assume that a single person rents a studio apartment in a qualified residential rental project which has elected the 20-50 test. AMGI is $25,000. As explained in the example above, the tenant's initial income must be less that $8750. Under 1986 Code §142(d)(3)(B), the tenant will remain qualified until his income exceeds $12,250. Two person families (initial income limit of $10,000) continue to qualify until income exceeds $14,000.

Where a tenant ceases to qualify as a low income tenant, the project is not immediately disqualified. So long as the next available unit of comparable or smaller size is rented to a tenant who does not exceed the income limit, the project remains in compliance.[80]

Example: In the example above, if the income of the tenant in the studio apartment exceeds $12,250, the project will remain in compliance so long as the next available studio is rented to a tenant with the income of no more than $8750. If the tenants in the one bedroom apartment have income in excess of $14,000, the project can remain in compliance by renting the next available one bedroom or studio to a qualifying tenant.

Under 1986 Code §142(d)(4), where the project charges significantly lower ("deep skewed") rent to low income tenants, the allowable income increase is up to 170% of the applicable income limit.

In order to qualify as a deep rent skewed project, the owner of the project makes an election to comply with the more stringent deep rent skewing requirements throughout the project period.[81] Deep rent skewing has three requirements:

(a) 15% or more of the *low income* units in the project are occupied by tenants whose income is 40% or less of AMGI;

(b) Gross rent for *each* low income unit in the project does not exceed 30% of the applicable income limit for the individuals occupying the unit; and

(c) Gross rent for *each* low income unit in the project does not exceed 1/3 of the average rent with respect to units of comparable size occupied by tenants other than low income tenants.

Example: Assume that the residential rental project has 200 units, with 20 studios and 20 one bedroom apartments to be occupied by low income tenants. The issuer has made a 20-50 election and AMGI is $25,000. In order for the project to qualify for deep rent skewing, six of the 40 low income units must be rented to single people with incomes of no more than $7000 or couples with incomes of no more than $8000. Additionally rent on the "40% units" for the individuals cannot exceed $175.00 per month (*i.e.*, [$7,000 ÷ 12] × 30%) and rent for couples may not exceed $200.00 (*i.e*, [$8,000 ÷ 12] × 30%). Rent on the "50% units" for individuals cannot exceed $218.75 and rent for couples cannot exceed $250.00. Finally, comparable units must rent to non-low income individuals for at least $656.25 and $750.00 (three times the rent on the "*50% limits*"). Assuming that the developer could (or would want to) meet such requirements, the developer would be entitled to treat low income tenants as qualified until incomes of couples exceed $17,000 ($13,600 for 40% tenants) and incomes of single people exceed $14,875 ($11,900 for 40% tenants), provided that once a tenant exceeds these limits, he must be replaced by a 40% tenant.

Note: The deep rent skewing election is made by the owner, not the issuer, while the 20-50, 40-60 election is made by the issuer. *Compare* 1986 Code §142(d)(1) *with* 1986 Code §142(d)(4)(B).

Finally, the owner of each qualified residential rental project must make an annual certification to the Treasury Department of continuing compliance.[82] Failure to file without reasonable cause subjects the owner to a $100 penalty under §6652(j) but does not affect the tax exemption on the bonds.[83]

4. Additional Restrictions

The 1986 Code tightens the restrictions on tax exempt bonds for airports, mass commuting facilities, docks and wharves by providing that the facility must be owned by a governmental unit.[84] Such exempt facilities may be leased to or managed by a private person.[85] In order to qualify as an acceptable lease or management agreement, the private lessee or manager must make an irrevocable election not to claim depreciation or investment credit on facility property.[86] The lease or management agreement term may not exceed 80% of the reasonably expected economic life of the facility [87] and the lessee or manager may not have an option to acquire the facility for less than fair market value.[88]

Under the 1954 Code, an airport facility includes facilities which are directly related and essential to servicing aircraft, enabling aircraft to take off and land, or transferring passengers or cargo to or from aircraft.[89] Examples include terminals, runways, hangars, loading facilities, repair shops, and land-based navigation aids.[90] Additionally, functionally-related and subordinate facilities may be included in the airport facility if of a character and size commensurate with the airport and if located at or adjacent to the airport.[91] Examples of functionally-related facilities include terminal restaurants and retail stores, ground transportation, parking areas, and accommodations for temporary or overnight use by passengers.[92]

Docks and wharves include functionally-related property such as vessel docking structures, loading and unloading

[80] 1986 Code §142(d)(3)(B).
[81] 1986 Code §142(d)(4)(B).
[82] 1986 Code §142(d)(7).
[83] *Id.*
[84] 1986 Code §142(b)(1)(A).
[85] 1986 Code §142(b)(1)(B).
[86] 1986 Code §142(b)(1)(B)(i).
[87] 1986 Code §142(b)(2)(B)(ii).
[88] 1986 Code §142(b)(1)(B)(iii).
[89] Regs. §1.103-8(e)(2)(ii)(*a*).
[90] *Id.*
[91] Regs. §1.103-8(e)(2)(ii)(*b*).
[92] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

equipment, and related storage, handling, office and passenger areas.[93] Mass commuting facilities include functionally-related facilities such as parking garages and repair shops.[94]

The 1986 Code restricts functionally-related facilities for airports, docks and wharves, and mass commuting facilities by providing that bond proceeds may not be used for any of the following private business uses:

(1) Hotels or lodging facilities;[95]

(2) Retail facilities (including food service) in excess of the size necessary to serve facility employees and passengers;[96]

(3) Any retail facility (other than parking) outside the exempt facility terminal;[97]

(4) Any office building other than for the governmental unit or the facility operating authority;[98]

(5) Any industrial park or manufacturing facility.[99]

Storage or training facilities directly related to airport, docks and wharves or mass commuting facilities are eligible for construction with bond proceeds.[100]

Finally, office space for all EFB facilities is restricted. The office space must be located on the premises of the related facility and not more than a *de minimis* amount of the office functions performed may relate to any activities other than the day-to-day operations of the facility.[101]

5. Hazardous Waste

Solid waste disposal facilities do not include most hazardous waste facilities.[102] Thus, the 1986 Code contains a separate provision for qualified hazardous waste facilities.[103] The facility must be for disposal of hazardous waste by incineration or entombment [104] and the term hazardous waste does not include radioactive waste.[105] Moreover, the facility must be used by the general public rather than the generator of the waste.[106]

Query: How often does the general public (as opposed to a generator) have need for a hazardous waste disposal facility? Apparently, Congress intended that the owner/operator of the facility be unrelated to the generator of the waste.[107]

6. Effective Dates

The changes in EFB treatment apply to bonds issued after August 15, 1986. Act §1311(a). Exceptions are made for bonds for facilities under construction on such date or under binding contract. *See* Act §1312. A current refunding exception is also provided. *See* Act §1313.

D. Single Family Housing

1. Introduction

Section 103A of the 1954 Code provides extensive rules for the issuance of tax exempt bonds to finance mortgages on owner occupied residences. The section provides for two types of tax exempt mortgage subsidy bond: qualified mortgage bonds and qualified veterans' mortgage bonds.[108] The 1986 Code generally retains the mortgage subsidy bond provisions (called "mortgage revenue bonds").

The mortgage revenue bond provisions of §103A of the 1954 Code are contained in §143 of the 1986 Code. The 1986 Code tightens the following restrictions on qualified mortgage bonds:

(1) Consistent with the use of proceeds for EFBs, the required portion of net proceeds to be used to finance mortgage loans to "first-time" home buyers is increased from 90% to 95%;

(2) The limit on qualifying purchase price is decreased from 110% of the average purchase price to 90% of such amount for non-targeted area residences and from 120% to 110% in the case of targeted area residences;

(3) The mortgagor's family income may not exceed 115% of the median family income in the "applicable area"; provided, however, that, one-third of the bond proceeds available for mortgage loans originated in targeted areas may be used to finance mortgage loans for targeted-area residences without regard to median family income and the remaining portion of such bond proceeds may be used to finance mortgage loans for targeted-area residences of mortgagors whose family income does not exceed 140% of the applicable median family income.

The termination date of the qualified mortgage bond program is extended from December 31, 1987 to December 31, 1988. *See* 1986 Code §143(a)(1)(B).

2. Use of Proceeds

Section 103A(e)(1) of the 1954 Code requires that 90% or more of the lendable proceeds of mortgage bonds be used to finance the residences of mortgagors ("first-time buyers") who had no present ownership interest in their principal residence at any time during the three-year period ending on the date their mortgage is executed. If there is more than one mortgagor with respect to a particular residence, then each must meet the three-year requirement. However, if a person is liable on the mortgage note without a present ownership interest in the residence (for example, a co-signer) then the three-year rule does not apply to such person.[109]

Section 143(d) retains the three-year rule but increases the percentage of net proceeds which must be so used to

[93] Regs. §1.103-8(e)(2)(iii).
[94] Reg. §1.103-8(e)(2)(iv).
[95] 1986 Code §142(c)(2)(A).
[96] 1986 Code §142(c)(2)(B).
[97] 1986 Code §142(c)(2)(C).
[98] 1986 Code §142(c)(2)(D).
[99] 1986 Code §142(c)(2)(E).
[100] 1986 Code §142(c)(1).
[101] 1986 Code §142(b)(2).
[102] Conference Report at II-704.
[103] 1986 Code §142(h).
[104] *Id.*
[105] Conference Report at II-707.
[106] *Id.*
[107] *See* Conference Report at II -707 n. 29.
[108] 1954 Code §103(A)(c)(1) and (3).
[109] Temp. Regs. §6a.103A-2(e)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

95%. This change is consistent with the change made with respect to EFB's.[110]

3. Purchase Price Limit

1954 Code §103A(f)(1) requires that qualified mortgage bonds finance mortgages where the acquisition cost of each residence does not exceed 110% of the average area purchase price applicable to such residence. Average area purchase price is calculated under Temp. Regs. §6a.103(A)-2(f)(3). 1986 Code §143(e) reduces the purchase price limitation to 90% of the average area purchase price applicable to such residence.

4. Income Limitation

Under §103A of the 1954 Code, issuers were not subject to limits on the income earned by mortgagors participating in a qualified mortgage bond program. Section 143(f) of the 1986 Code, however, places a family income restriction on participants in qualified mortgage bond programs.

Section 143(f)(1) requires that all owner-financing provided under a qualified mortgage bond financing be provided for mortgagors whose family income is 115% or less of the applicable median family income. Family income is determined under rules similar to those used with respect to qualified residential rental projects.[111] Applicable median family income is the greater of AMGI [112] for the area in which the residence is located or the statewide median gross income for the state in which residence is located.[113] In the case of financing provided for targeted areas [114] one-third of the financing may be provided without income limitation and the remainder of targeted area financing is subject to a 140% of applicable median family income limit.[115]

5. Qualified Veterans Mortgage Bonds

The qualified veterans mortgage bonds provisions of §103A(c)(3) are generally retained under §143(b) of the 1986 Code. The one change is the increase of the percentage of proceeds required to be used for the exempt purpose from 90% to 95%.[116]

6. Effective Dates

The changes to the qualified mortgage bond and qualified veterans mortgage bond rules apply to bonds (including refunding bonds) issued after August 15, 1986. Act §1311(a). Conference Report at II-716-17. A special transition rule is applicable to current refundings after such date. *See* Act §1312 and Conference Report at II-716-17.

E. Small Issue, Student Loan, and Redevelopment Bonds

1. Small Issue Bonds

The small issue bond exception to the IDB rules is incorporated in §144(a) of the 1986 Code with one significant change. Section 103(b)(6)(A) of the 1954 Code provides that substantially all of the proceeds of the exempt small issue must be spent for the exempt purpose. As with exempt facility bonds, the Service interpreted "substantially all" to mean 90% of the proceeds net of costs of issuance.[117] The Act tightens the substantially all to require that 95% of the net proceeds be so used.[118] Also, costs of issuance are not subtracted in the calculation of net proceeds.[119]

The sunset provision for the small issue exemption with respect to manufacturing and farm property is extended to December 31, 1989.[120] For uses other than manufacturing or farm property, the provision terminates on December 31, 1986 as scheduled. 1986 Code §144(a)(12(A).

2. Student Loan Bonds

Section 103(o)(3) of the 1954 Code provides that qualified student loan bonds are tax exempt if all or a major portion of the proceeds are used to make Federal Guaranteed Student Loans or Parents Loans, for Undergraduate Students. Under the 1986 Code, the restrictions on student loan bonds are tightened by the requirement that 90 to 95% (depending on the loan program) of the bond proceeds be used directly or indirectly to make student loans.[121] Further, the student borrower must be either a resident of the issuing state or enrolled in an educational institution in such state.[122]

3. Qualified Redevelopment Bonds

The 1986 Code also contains a new type of PAB, described in §144(c). The qualified redevelopment bond is tax-exempt if 95% of the proceeds are used with respect to a "designated blighted area" to:

(a) Acquire property by eminent domain, and clear and prepare the land for redevelopment;

(b) Rehabilitate real property so acquired;

(c) Relocate persons displaced under (a).[123]

Qualified redevelopment bonds may not be used to construct buildings for use by nongovernmental persons.[124] A "designated blighted area" is any blighted area designated by the governing body of a local general purpose governmental unit in the jurisdiction of which the area is located.[125] A blighted area may be designated by such governing body based on the "substantial presence of factors such as excessive vacant land on which structures were previously located, abandoned or vacant buildings, substandard structures, vacancies, and delinquencies in payment of real property taxes." [126] However, there may not be more than 20% of the total assessed value of real estate in a jurisdic-

[110] *Cf.* 1986 Code §142(a).
[111] *See* 1986 Code §143(f)(2)(B).
[112] *See* 1986 Code §142(d)(2)(B).
[113] 1986 Code §143(f)(4).
[114] *See* 1954 Code §103A(k); 1986 Code §143(j).
[115] 1986 Code §143(f)(3).
[116] 1986 Code §143(b)(1).
[117] Regs. §1.103-10(b)(1)(ii) (incorporating Regs. §1.103-8(a)(1)(i)).
[118] 1986 Code §144(a)(1).
[119] 1986 Code §150(a)(3).
[120] 1986 Code §144(a)(12)(B).
[121] 1986 Code §144(b)(2).
[122] 1986 Code §144(b)(3).
[123] 1986 Code §144(c)(3).
[124] *See* 1986 Code §144(c)(3)(B) and Conference Report at II-719.
[125] 1986 Code §144(c)(4)(A).
[126] 1986 Code §144(c)(4)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tion designated as blighted.[127] An area may not receive a "blighted" designation unless it is at least 100 acres and is "contiguous and compact." [128] However, areas as small as ten acres may be designated if no more than 25% of the area will be provided to one person.[129] The repayment of qualified redevelopment bonds is restricted to certain types of tax revenue.[130] Bonds may be repaid by incremental tax revenues, general tax revenues or by a combination of the two.[131] No owner or user of property in the financial area may be subject to a charge, fee or tax rate which is different from that imposed on similarly situated owners outside the area.[132]

4. Effective Dates

The changes to the small issue and student loan provisions apply to bonds (including refunding bonds) issued after August 15, 1986. Act §1311(a); Conference Report at II-711 and II-713. Exceptions for binding contracts and certain current refundings are provided. *See* Act §§1312-13; Conference Report at II-712 and II-713.

The new redevelopment bond provision applies to bonds issued after August 15, 1986. Act §1311(a); Conference Report at II-725.

F. Qualified §501(c)(3) Bonds

1. Definition

The requirements for tax-exempt bonds whose proceeds are used by tax-exempt §501(c)(3) entities are tightened consistent with the changes in the definition of PABs. Under the 1954 Code, a §501(c)(3) organization was treated as an "exempt person" under the IDB rules.[133] So long as the trade or business and security interest tests were not met [134] and the organization did not use the proceeds in an unrelated trade or business,[135] the interest on the bonds was tax exempt.

Under the 1986 Code, such bonds are exempt only if all property acquired under the bonds is owned by a §501(c)(3) organization or a governmental unit,[136] and, assuming the §501(c)(3) organization were deemed a governmental entity, the bond would not be a PAB under §141(a) if the trade or business and security interest tests were applied by substituting 5% for 10%.[137] This rule also subjects the §501(c)(3) organization to the 95% use of net proceeds rule and the 2% limitation on bond issuance costs financed by bond proceeds.[138]

2. Bond Limit

Section 501(c)(3) organizations are also subject to a new $150,000,000 limit on the amount of tax exempt bonds which they may have outstanding at one time during any three-year period.[139] An otherwise qualified §501(c)(3) bond will not be tax exempt if the aggregate face value of the §501(c)(3) issue to which it belongs, when added to the outstanding bonds of the organization, exceeds $150,000,000.[140] The limit is designed to operate similar to the $40,000,000 per taxpayer limit on small issue IDBs and EFBs.[141] Bonds issued with respect to a hospital [142] and bonds which pursuant to election are not treated as qualified 501(c)(3) bonds are excluded from the $150,000,000 limit.[143] Bonds for which such an election is made, however, are subject to the state volume cap. *See* Conference Report at II-727.

3. Effective Date

The §501(c)(3) provisions generally apply to bonds (including refunding bonds) issued after August 15, 1986. *See* Act §1311; Conference Report at II-727. Where construction commenced or a binding contract existed prior to such time, the new rules do not apply. A transition rule is provided for certain current refundings and some advance refundings of bonds issued prior to August 16, 1986. *See* Act §§1312 and 1313; Conference Report at II-727-28.

G. Volume Cap

1. Limitation

Under the 1954 Code, states were subject to a ceiling on the amount of student loan bonds and IDBs which could be issued in any calendar year.[144] Low and moderate income housing IDBs were excepted from this volume cap.[145] The state volume cap for each year through 1986 was the greater of $200,000,000 or $150 multiplied by the state's population.[146] For years after 1986, the cap was to be reduced to $100 per person to account for the termination of the small issue exemption.[147]

Section 103A(g) of the 1954 Code provides a similar, but separate, volume cap on qualified mortgage bonds. The mortgage bond ceiling is the greater of $200,000,000 or nine percent of the average annual aggregate principal amount of mortgages executed in the state for single-family, owner-occupied residences during the preceding three years.[148]

The 1986 Code combines the separate IDB/student loan and qualified mortgage bond volume caps into a single cap at the reduced amount of $75 per state resident or $250 million, whichever is greater.[149] The cap is reduced to $50 per resident or $150 million after 1987.[150] Qualified residential rental project bonds are included under the cap for the

[127] 1986 Code §144(c)(4)(C).
[128] 1986 Code §144(c)(4)(D)(i).
[129] 1986 Code §144(c)(4)(D)(ii).
[130] *See* 1986 Code §144(c)(5) and (c)(2)(B).
[131] Conference Report at II-718.
[132] 1986 Code §144(c)(5).
[133] 1954 Code §103(b)(3)(B).
[134] 1954 Code §103(b)(2). *See* II, B, 2, *supra.*
[135] 1954 Code §103(b)(3)(B).
[136] 1986 Code §145(a)(1).
[137] *Id. See* Conference Report at II-726.
[138] Conference Report at II-726. *See* II, H, 5, *infra,* for discussion of the 2% limitation on bond issuance costs.
[139] 1986 Code §145(b)(1).
[140] 1986 Code §145(b)(1).
[141] *Compare* 1986 Code §144(a)(10) *with* 1986 Code §145(b)(1).
[142] *See* 1986 Code §145(c), defining "qualified hospital bond."
[143] 1986 Code §145(d).
[144] *See* 1954 Code §103(n); Conference Report at II-734.
[145] 1954 Code §103(n)(7)(B).
[146] 1954 Code §103(n)(4)(A).
[147] 1954 Code §103(n)(4)(C).
[148] 1954 Code §103A(g)(4).
[149] 1986 Code §146(d)(1).
[150] 1986 Code §146(d)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

first time.[151] A three year carryforward of unused cap amounts is permitted for years after 1985.[152]

2. Veterans' Bonds

Under the 1954 Code, qualified veterans' mortgage bonds were subject to a separate state ceiling based on the amount of qualified veterans' bonds previously issued by the state.[153] This same volume cap is retained under the 1986 Code.[154]

3. Effective Date

The changes to the volume cap generally apply to bonds issued after August 15, 1986. Act §1311; Conference Report at II-741. An exception is provided for certain current refundings and a transition rule is provided for construction and binding contracts prior to the effective date. *See* Act §§1312 and 1313; Conference Report at II-741-43.

H. Other Requirements for PABs

1. Introduction

Section 147 of the 1986 Code consolidates several restrictions on PABs that were applicable to IDBs. The substantial user requirement,[155] the 120% bond maturity limit,[156] the 25% limit on land acquisition cost,[157] the existing-property acquisition rules (1954 Code §103(b)(17)), the prohibition against use of bond proceeds for sky boxes, airplanes, gambling establishments etc.,[158] and the public approval requirement [159] carry over from the 1954 Code. Minor extensions of the restrictions are made.

2. Bond Maturity Limit

Under §103(b)(14) of the 1954 Code most exempt IDBs were taxable if the weighted average maturity of the bonds exceeded 120% of the reasonably expected economic life of the financed facilities. This restriction is carried over to 1986 Code §147(b). Additionally, the 120% bond maturity limit is extended to §501(c)(3) bonds.[160]

3. Prohibition of Certain Uses

Under the 1954 Code, no part of the proceeds of an exempt facility,[161] industrial park,[162] or small issue IDB,[163] may be used to provide any airplane, skybox, or other private luxury box, any health club facility, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.[164] Under the 1986 Code, the prohibition is extended to all PABs,[165] with a special exception for health club facilities owned by §501(c)(3) organizations if the health club facility is directly used for the purpose of qualifying for the tax exemption.[166] Qualified redevelopment bonds are subject to the additional restriction that proceeds may not be used to provide any private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities or racetracks.[167]

4. Public Approval Requirement

Under §103(k) of the 1954 Code all IDBs are subject to a public approval requirement. Under the 1986 Code, the public approval requirement extends to PABs, including §501(c)(3) bonds.[168]

5. Limitation on Bond-Funded Issuance Costs

Under the 1954 Code, costs of issuance were treated as neutral costs and were not subject to any limitation. However, §147 of the 1986 Code provides a new 2% limitation on the amount of bond proceeds which can be spent for cost of issuance of PABs.[169] The provision makes the (otherwise-qualified) PAB taxable if bond proceeds are used to pay costs of issuance in excess of 2% of the aggregate face amount of the bonds.[170] A higher limit of 3.5% is allowed for qualified mortgage bonds and qualified veterans' mortgage bonds if the aggregate authorized face amount of the issue does not exceed $20,000,000.[171]

Query: Since many transactions will have costs of issuance in excess of 2%, such excess will not be bond-funded. How can it be determined whether more than 2% of bond proceeds have or have not been applied to pay costs of issuance or any other development costs under the "money is fungible" theory?

Costs of issuance subject to the 2% limitation include all costs incurred in connection with the financing.[172] The Conference Report [173] lists the following specific costs:

(1) underwriters' spread (whether realized directly or derived through purchase of the bonds at a discount below the price at which they are expected to be sold to the public);

(2) counsel fees (including bond counsel, underwriter's counsel, issuer's counsel, company counsel in the case of borrowings such as those for exempt facilities, as well as any other specialized counsel fees incurred in connection with the borrowing);

(3) financial advisor fees incurred in connection with the borrowing;

(4) rating agency fees;

(5) trustee fees incurred in connection with the borrowing;

[151] *See* Conference Report at II-738.
[152] 1986 Code §146(f).
[153] 1954 Code §103A(o).
[154] 1986 Code §143(1)(3); *See* Conference Report at II-737.
[155] 1954 Code §103(b)(13).
[156] 1954 Code §103(b)(14).
[157] 1954 Code §103(b)(16).
[158] 1954 Code §103(b)(18).
[159] 1954 Code §103(k).
[160] Conference Report at II-730. *See* 1986 Code §147(b) and (h)(2).
[161] 1954 Code §103(b)(4).
[162] 1954 code §103(b)(5).
[163] 1954 Code §103(b)(6).
[164] 1954 Code §103(b)(18).
[165] 1986 Code §147(e).
[166] 1986 Code §147(h)(2); Conference Report at II-731.
[167] 1986 Code §144(c)(6)(B).
[168] 1986 Code §147(f) and (h)(2).
[169] 1986 Code §147(g).
[170] 1986 Code §147(g)(1).
[171] 1986 Code §147(g)(2).
[172] Conference Report at II-729. The Conference Report also states that, in general, all costs treated as costs of issuance under pre-1986 TRA regulations and rulings are also treated as such under 1986 Code §147(g).
[173] Conference Report at II-729-30.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(6) paying agent and certifying and authenticating agent fees related to issuance of the bonds;

(7) accountant fees (*e.g.*, accountant verifications in the case of advance refundings) related to issuance of the bonds;

(8) printing costs (for the bonds and of preliminary and final offering materials);

(9) costs incurred in connection with the required public approval process (*e.g.*, publication costs for public notices generally and costs of the public hearing or voter referendum); and

(10) costs of engineering and feasibility studies necessary to the issuance of the bonds (as opposed to such studies related to completion of the project, but not to the financing).

Costs such as bond insurance premiums (including letter of credit fees) treated as interest for arbitrage purposes are not included as costs of issuance.[174] This standard probably also will apply to premiums generated by sale of bonds at a price above par.

6. Effective Date

The changes in the PAB restrictions generally apply to bonds, including refunding bonds, issued after August 15, 1986. Act §311(a). Current refunding and binding contract transition rules apply to the prohibited facility change. *See* Conference Report at II-731-32. The public approval provision applies to bonds (including refunding bonds) issued after December 31, 1986. Conference Report at II-732.

I. Arbitrage Restrictions

1. *Introduction*

The arbitrage restrictions of §103(c) of the 1954 Code are incorporated into §148 of the 1986 Code and, consistent with revisions made to other tax-exempt bond restrictions, further tightened.

2. Arbitrage Bond Definition

Section 103(c)(2) of the 1954 Code defines an arbitrage bond as any obligation issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly to acquire securities or obligations reasonably expected to produce a materially higher yield than the yield on the obligations of such issue or to replace funds so invested.

The definition of an arbitrage bond remains consistent with the 1954 Code,[175] with the 1986 Act clarifying that intentional acts to earn arbitrage after issuance will cause loss of tax exempt status.[176]

3. Higher Yielding Investments

The types of investments which produce arbitrage are expanded to include annuity contracts and "any investment-type property." [177]

4. Temporary Periods

Temporary period exceptions [178] remain unchanged except for pooled financings (loans, other than nonpurpose obligations, to two or more persons) where the temporary period is reduced to six months.[179] The optional waiver (contained in pre-1986 TRA regulations) of the temporary period in exchange for greater yield is deleted.[180] Loan repayment proceeds in pooled financings are limited to three month temporary periods; student loan pools are entitled to 18 month periods through 1988.[181]

Note: The general temporary periods for tax-exempt bonds are different than the six month temporary period for the PAB rebate requirement discussed at 7, *infra*.

5. 4R Funds

Pursuant to Regs. §1.103-14(d)(1), a reasonably required reserve and replacement fund ("4R Fund") is not subject to yield restriction. Under this regulation a 4R Fund generally may not exceed 15% of the face amount of the issue. 4R Funds continue to be excepted from arbitrage restrictions [182] under the 1986 TRA, but are limited to 10% of the proceeds of the issue, unless the issuer establishes that a higher amount is necessary.[183]

6. Computation of Bond Yield

State of Washington v. Comr. [184] held that proper computation of bond yield required reduction to account for costs of issuance. This has the effect of permitting higher yields on acquired nonpurpose obligations. Section 148(h) of the 1986 Code requires in effect that calculations of bond yield be made without reduction for costs of issuance. *See* Conference Report at II-745-46.

Bond insurance premiums continue to be treated as interest under the 1986 Code.[185] The Conference Report clarifies that this treatment extends to other credit enhancement fees such as letter of credit fees if the credit enhancement results in a net savings in interest expense. The fees are limited to fees arising from an arm's-length transaction and fees representing reasonable charges for the credit risk.[186]

7. Rebate Requirement

Section 103(c)(6)(D) of the 1954 Code requires the issuers of IDBs (other than low and moderate housing bonds) to rebate to the United States the earnings on acquired nonpurpose obligations in excess of the earnings which would accrue if the obligations yielded the same rate as the bonds.

The arbitrage rebate requirement is extended under the 1986 Code to all tax-exempt bonds other than mortgage revenue bonds.[187]

[174] Conference Report at II-730.
[175] *See* 1986 Code §148(a).
[176] *Id.*, second sentence.
[177] 1986 Code §148(b)(2).
[178] 1986 Code §148(c)(1).
[179] 1986 Code §148(c)(2).
[180] 1986 TRA §1301(c).
[181] 1986 Code §148(c)(2)(B) and (C).
[182] 1986 Code §148(d)(1).
[183] *Id.*
[184] 692 F. 2d 128 (D.C. Cir. 1982).
[185] Regs. §1.103-13(c)(8); Conference Report at II-747.
[186] Conference Report at II-747.
[187] 1986 Code §148(f).

8. Nonpurpose Obligation Limit

Under 1954 Code §103(c)(6)(C), issuers of IDBs (other than low and moderate housing bonds) may not invest amounts in nonpurpose obligations in excess of 150% of the scheduled interest and principal payments for the year. The 1986 TRA extends the 150% of annual debt service limitation on investments in nonpurpose obligations to all PABs except for §501(c)(3) bonds.[188]

9. Optional Penalty

The Treasury also has the option to impose a 50% penalty in lieu of loss of tax exemption for rebate violations.[189]

10. Effective Dates

The changes in the arbitrage rules generally are effective for bonds (including refunding bonds) issued after August 15, 1986. Act §1311(a); Conference Report at 749. The restriction on investments in annuity contracts applies to bonds (including refunding bonds) issued after September 25, 1985. Act §1314(a). The repeal of *State of Washington* applies to bonds (including refunding bonds) issued after December 31, 1985. Act §1314(c). *See* Conference Report at II-749-50.

J. Registration and Other Requirements for all Tax Exempt Obligations

1. Registration Requirement

The registration requirement of 1954 Code §103(j) is carried over to 1986 Code §149(a).

2. Prohibition on Federal Guarantee

The Federal guaranty prohibition of 1954 Code §103(h) is carried over into §149(b) of the 1986 Code.

Additionally, under §1316(e) of the 1986 TRA, refundings of certain federally-guaranteed bonds are permitted. The refunded bonds must have been issued before April 15, 1983 or have been not taxable by reason of §631(c)(2) of the Tax Reform Act of 1984.[190] The refunding bond: (a) must have a maturity date not later than the maturity date of the refunded bond, (b) may not exceed the outstanding amount of the refunded bond; (c) must have a weighted average interest rate which is lower than the weighted average interest rate on the refunded bond; and, (d) the net proceeds must be used to redeem the refunded bond not later than 90 days after the date of the issuance of the refunding bond.[191]

3. Information Reporting

Section 103(l) of the 1954 Code requires issuers of IDBs and certain other bonds to file information returns. The information reporting requirement is extended to all tax-exempt bonds.[192]

4. Advance Refundings

Regs. §1.103-15 prevents IDBs and mortgage revenue bonds from being advance refunded. Section 149(d) extends the prohibition on advance refundings to all PABs (except §501(c)(3) bonds) and reduces the advance refunding period from 180 days to 90 days.[193] Certain new technical requirements are imposed on permitted advance refundings.[194]

K. Special Rules

1. Volunteer Fire Department Bonds

The rules for bonds of certain volunteer fire departments exempt under §103(i) of the 1954 Code continue in §150(e) of the 1986 Code, subject to the requirement that at least 95% of the net proceeds be used for qualified purposes.

2. Loss of Deductions for Change in Use

1986 Code §150(b) provides new rules resulting in the loss of tax deductions for rent, interest or equivalent amounts by persons using PAB property if the use of the property is changed to a nonqualifying use. The loss of deductions is in addition to loss of the tax-exemption for the bonds. *See* Conference Report at II-733.

Homeowners whose homes are financed under qualified mortgage bonds or qualified veterans' mortgage bonds will lose their deduction for mortgage interest if there is a continuous period of one year in which the home is not the principal residence of at least one mortgagor.[195] Owners of qualified residential rental projects will lose their mortgage interest deductions for any period in which the qualified residential rental project rules of §142(d) of the 1986 Code are not complied with.[196]

Where a facility financed with qualified §501(c)(3) bonds is used in a trade or business of a person other than the §501(c)(3) organization or a governmental unit and the §501(c)(3) organization continues to own the property, the §501(c)(3) organization will be deemed to have unrelated business income of not less than the fair rental value of the property used by the nonexempt person.[197] Interest paid on exempt facility bonds is not deductible by the owner if the facility is not used for the purpose for which a tax-exempt bond could be issued on the date of such issue.[198] Similarly, for airports, docks and wharves and mass commuting facilities, if the facilities are privately owned, the interest paid on the bonds is nondeductible by the owner.[199]

3. Effective Dates

The change in use requirement applies to changes occurring after August 15, 1986 with respect to financing provided after such date. Act §1311(a); Conference Report at II-733.

---

[188] 1986 Code §148(d)(3). *See* Conference Report at II-751.
[189] 1986 Code §148(f)(7).
[190] 1986 TRA §1316(e)(1).
[191] 1986 Code §1316(e)(2).
[192] 1986 Code §149(e).
[193] 1986 Code §149(d)(5).
[194] *See* 1986 Code §149(d)(3).
[195] 1986 Code §150(b)(1)(A). The disallowance applies to interest accruing on and after the beginning of the one-year period. *Id.*
[196] 1986 Code §150(b)(2).
[197] 1986 Code §150(b)(3).
[198] 1986 Code §150(b)(4).
[199] 1986 Code §150(b)(5). *See* §142(b)(1)(A).

L. Effective Date Provisions

1. General

The changes made in the 1986 Code provisions with respect to tax-exempt bonds generally apply to bonds issued after August 15, 1986.[200]

2. Certain Construction and Binding Contracts

The changes will not apply to bonds (other than refunding bonds) which were subject to an inducement resolution or other comparable preliminary approval adopted by an issuing authority before September 26, 1985 where one of the three following tests is satisfied:

(a) the original use commences with the taxpayer and construction, reconstruction, or rehabilitation began before September 26, 1985;

(b) the original use commences with the taxpayer and the taxpayer had a binding contract to incur more than 10% of the reasonably anticipated cost of the construction, reconstruction, or rehabilitation of the facility before September 26, 1985 and some of the expenditures were made before such date; or,

(c) the taxpayer acquired the facility pursuant to a binding contract entered into prior to September 26, 1985.[201]

Notwithstanding these construction and binding contract exceptions, the following changes apply to the bonds issued after August 15, 1986:

(a) the substantially all requirements under §103 of the 1954 Code are changed to 95% of the net proceeds;[202]

(b) the office space limitation of 1986 Code §142(b)(2);[203]

(c) the changes to the qualified mortgage bonds and qualified veterans' mortgage bonds under §143 of the 1986 Code;[204]

(d) the 1986 Code §144(a)(11) limitation on acquisition of depreciable farm property and the 120% maturity limitation;[205]

(e) the public approval and cost of issuance limitations under §147(f), (g);[206]

(f) the new arbitrage rules;[207]

(g) the information reporting requirement rules for bonds issued after December 31, 1986;[208]

(h) the new change in use rules.[209]

3. Current Refundings

The changes do not apply to certain current refundings of bonds issued before August 16, 1986 or bonds subject to the construction or binding contract exception described above.[210] The amount of the refunding issue may not exceed the amount of the refunded issue and the maturity of the refunding issue must either comply with the 120% maturity limitation or may not be longer than 17 years from the date of the original issue.[211]

Notwithstanding the current refunding exception, the following changes apply to the bonds:

(a) the public approval requirement of §147(f), if the maturity date of the refunding bond is later than the maturity date of the refunded bond;[212]

(b) the cost of issuance limitation under §147(g);[213]

(c) the new arbitrage rules;[214]

(d) the information reporting requirement rules for bonds issued after December 31, 1986;[215]

(e) the new change in use rules.[216]

III. Alternative Minimum Tax

The alternative minimum tax provisions made significant changes with respect to tax-exempt interest. These provisions are analyzed in Chapters 32 and 33. Generally, tax-exempt interest on PABs (other than qualified §501(c)(3) bonds) issued after August 7, 1986 is treated as a tax preference. *See* 1986 Code §57(a)(5). Additionally, tax-exempt interest received by a corporation will increase the corporation's book income so as to enter into the 50% book income over taxable income adjustment of 1986 Code §56(f).

---

[200] 1986 TRA §1311(a).
[201] 1986 TRA §1312(a).
[202] 1986 TRA §1312(b)(1)(A), (B).
[203] 1986 TRA §1312(b)(1)(A).
[204] 1986 TRA §1312(b)(1)(C).
[205] 1986 TRA §1312(b)(1)(D) and (E).
[206] 1986 TRA §1312(b)(1)(F) and (G). The public approval requirement applies to bonds issued after December 31, 1986. 1986 TRA §1312(b)(2).
[207] 1986 TRA §1312(b)(1)(H).
[208] 1986 TRA §1312(b)(1)(I) and (b)(2).
[209] 1986 TRA §1312(b)(1)(J).
[210] 1986 TRA §1313(a)(1) and (2).
[211] *Id.*
[212] 1986 TRA §1313(a)(3)(A). This rule applies only if the refunding bond is issued after December 31, 1986. 1986 TRA §1313(a)(3), last sentence.
[213] 1986 TRA §1313(a)(3)(B).
[214] 1986 TRA §1313(a)(3)(C).
[215] 1986 TRA §1312(b)(3)(D).
[216] 1986 TRA §1313(a)(3)(E).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 31

AMENDMENTS RELATED TO TRANSACTIONS INVOLVING DEBT INSTRUMENTS

Harrison B. McCawley, Esq.
Silverstein and Mullens
Washington, D.C.

The Code contains a number of provisions, most of which were enacted by the various revenue acts of the 1980's (ERTA, TEFRA and the 1984 TRA), relating to the timing and the computation of the amount of interest includible in gross income by the holder and deductible by the issuer of a "debt instrument." This term is defined as a bond, debenture, note or certificate or other evidence of indebtedness.[1] Since the term will be used frequently herein, it will be referred to by the symbol "DI." In April of 1986, proposed regulations were issued which interpreted and provided special rules and definitions for most of the Code provisions relating to the timing and computation of interest both for purposes of inclusion in gross income and qualification for deduction (without regard to other provisions of the Code restricting the deductibility of interest once the proper taxable year for accrual and the amount have been determined). While sometimes referred to as the "OID" (original issue discount) regulations, they relate not only to §§1271-1275 and §483, but also to §446 (general rules of tax accounting for the timing and computation of interest by both cash and accrual basis taxpayers) and §482.[2] The proposed regulatory provisions relating to short-term obligations have been adopted, to a large extent, by the 1986 TRA amendments to §1271 and §§1281-1283.

The Code provisions relating to DIs and the proposed regulations have, as their principal goal, the conformation of the Code provisions to the methods generally recognized by the commercial marketplace for computing the time value of money. Interest, for all purposes, is computed on the basis of compounding where not paid currently. This is known as "economic accrual," or accrual on a "constant interest basis." It reflects the principle that where interest is not paid currently, the amount accrued is added to the principal and itself generates interest. This principle was first reflected in the Code by amendments made to the rules governing the accrual of OID under the predecessor to §1272 in 1982.[3] The only area not affected by these Code provisions and the proposed regulations was the amortization of bond premium under §171. Under the 1986 TRA, this, too, must be computed using economic accrual. Most of the other amendments made to the Code provisions relating to the accrual of interest on debt instruments are in the form of "technical corrections" of pre-1986 TRA law.

One significant amendment to §1272 (relating to the computation of OID) is contained in the 1986 Act provisions governing "real estate mortgage investment conduits" (REMICS) and the holders of interests in such entities (Act §§671-675; subtitle H of title VI). This amendment is discussed in detail in Chapter 42, *infra*.

In addition to the amendments described above, the 1986 Act provides a number of "technical corrections" concerning market discount bonds.

This chapter covers the following topics:

(1) bond premium;

(2) short-term obligations;

(3) market discount bonds;

(4) technical and clerical amendments;

(5) amendments relating to REMIC interests;

(6) below market interest loans.

I. Bond Premium

A. Introduction

Where a DI is acquired, and the holder's basis immediately after acquisition exceeds the amount payable on maturity or on earlier call date (where the the amount payable on such earlier call date results in less premium to be amortized) such excess may be amortized over the period to maturity or earlier call date, and the amount attributable to the taxable year is allowed as a deduction.[4] This general rule applies only to DI's the interest on which is not excludable from gross income.[5]

Under §171, before its amendment by the 1986 TRA,[6] the method for determining the amount of amortizable premium deductible for a taxable year was the method "regularly employed by the holder, if such method is reasonable." [7] The regulations make it clear that straight line or ratable amortization is an acceptable method.[8]

[1] *See* §1275(a)(1). This same definition applies to the term "bond" where used in the Code provisions (a holdover from previous terminology); *See* §§171(d) and 1278(a)(3).

[2] LR-189-84, 51 Fed. Reg. 12022 (April 8, 1986), with corrections of clerical errors in 51 Fed Reg. 23431 (June 27, 1986).

[3] §1232A as enacted by P.L. 97-248.

[4] §171(b).

[5] §171(a)(1) and (2).

[6] P.L. 99-514, hereinafter referred to as "the Act."

[7] §171(b)(3).

[8] Regs. §1.171-2(f).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Under pre-1986 TRA law, the definition of "bond" provided by §171(d) restricted the application of §171 to DIs "issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof)." Also excluded were DIs held as stock in trade, inventory or for sale to customers.

Congress determined that since there was no logical basis for not doing so, the provisions for amortization of bond premium should be brought into line with those for the accrual of bond discount.

B. Statutory Provisions

Act §1803(a)(11) amends §171(b)(3) (which sets forth the method for computing the amortization of bond premium) to provide that, except as otherwise provided by regulations, the amount of deductible premium for the taxable year is to be made on the basis of the "taxpayer's yield to maturity."

Observation: Note that the *taxpayer's* yield to maturity is used, not the yield of the DI. This will be explained in the analysis below.

The yield is to be based on the taxpayer's basis (for purposes of determining loss on sale or exchange) in the DI, compounding at the close of each accrual period (as defined in §1272(a)(5).[9]

Note: The accrual period of a DI is determined under the rules set forth in Prop. Regs. §1.1272-1(d).

Where the call date is used instead of the maturity date, *i.e.*, where it is assumed that the DI will be called on the call date at the call price, and, will thus result in a lower amount of amortizable premium, the DI is to be treated as maturing on such earlier date for the call price and then reissued on that date for such call.[10]

The restriction of these provisions to DI's issued by corporations (or governmental agencies) is striken from §171(d). Act §1803(a)(11)(B). Thus, premium on a DI issued by an individual may now be amortized.

The above amendments all apply to obligations issued after September 27, 1985. Act §1803(a)(11)(C)(i).

Under §171(c), as in effect under the pre-1986 Code, to amortize bond premium, the taxpayer had to make an election to have §171 apply. Such an election, if made with respect to any bond, applied to all bonds held at the beginning of the first taxable year to which the election applied, and to all bonds thereafter acquired. The election was irrevocable, unless, on application by the taxpayer, the Commissioner allowed such revocation, subject to conditions as the Commissioner deemed necessary to revoke the election. Act §1803(a)(11)(C)(ii) provides that where such an election was in effect on October 22, 1986 (date of Act's enactment), it is to apply to obligations issued after September 27, 1985 only if the taxpayer so chooses.

Section 171(e), as added by Act §643 (redesignating former §171(e) as §171(f)), provides that except as provided in regulations, the amount of any amortizable bond premium with respect to which a deduction is allowed under §171(a)(1) for any taxable year is to be treated as interest for purposes of this title. This provision generally applies to obligations acquired after October 22, 1986, in taxable years ending after such date. Act §643(b)(1).

Note: This clarifies what, without the specific statutory provision, may have been open to considerable dispute. Where a taxpayer invests $105,000 in exchange for a series of future payments to be made under a bond with a redemption price at maturity of $100,000, the amount of the premium amortizable each year offsets the interest income from the bond, reducing the amount of the latter includible in taxable income. Without §171(e), the entire amount of interest payments received without the amortization offset could be used in determining the amount of interest deductible under §163(d). Thus, §171(e) seems a reasonable measure to prevent avoidance of the restriction on interest on investment indebtedness.

In addition to the above provisions, Act §1803(a)(12) adds §171(b)(4) to provided that if a bond is acquired by a person in exchange for other property, and the basis of the bond is determined (in whole or in part) by reference to the basis of such other property, for purposes of §171, the basis of the bond is not to exceed its fair market value immediately after such exchange.

> *Example*: Individual A transfers to a wholly owned corporation property with a basis of $12,000 in exchange for a debenture of the corporation with a redemption price at maturity of $10,000. The basis of the debenture in A's hands, under §358(a)(1) is $12,000, and, without this special rule, there would be $2,000 of bond premium subject to amortization. However, if the fair market value of the debenture is $9,500, this is its basis for purposes of §171 under the special rule of §171(b)(4), and, consequently, there is no bond premium.

Note: There is no market discount since this rule applies *only for purposes of §171.*

Further, §171(b)(4) provides that a similar rule is to apply in the case where the bond is held by any person whose basis is determined in whole or in part by reference to the transferor in the above described situation. Thus, if A transfers the bond to another controlled corporation in exchange for its stock immediately after the first transaction, the basis of the bond in the hands of such second corporation cannot exceed $9,500.

Section 171(b)(4)(B) provides that these rules are not to apply to bonds received in exchange for other bonds in connection with a reorganization (as defined by §368). If any portion of the basis of the taxpayer in such a bond is not taken into account in determining bond premium by reason of §171(b)(4)(A), such portion is not to be taken into account in determining premium on any bond received in the reorganization exchange. Thus, if A's basis in the bond received from the controlled corporation is limited to $9,500 as in the example given above, and this bond is exchanged for another bond in a reorganization, A's basis in the bond received, for purposes of determining bond premium, cannot exceed $9,500.

[9] §171(b)(3)(A)(i) and (ii).
[10] *See* §171(b)(1)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The amendments made to §171(b)(4) apply to exchanges after May 6, 1986. Act §1803(a)(12)(B).

C. *Detailed Analysis*

The following example demonstrates how the provisions discussed above operate.

> *Example*: On January 1, 1987, A purchases a bond for $55,242.14. The bond pays coupon interest semiannually of $3,000, and is redeemable at maturity at the expiration of three years from the date of purchase for $50,000. The taxpayer's yield to maturity, based on the purchase price, is 8% compounded semiannually.[11] For the first six-month accrual period, A computes interest based on the 8% annual yield as $2,209.69 ($55,242.14 x .04). Interest received is $3,000. There is, therefore, $790.31 of bond premium allocable to the first accrual period. This is subtracted from the $55,242.14 basis to compute the premium for the next period. This is computed to be $821.93. Premium amortized on this constant interest basis for the subsequent four accrual periods is: $854.80, $889.00, $924.56, and $961.54. These amounts are all deductible as interest. Further, the taxpayer's basis in the bond is reduced by the amount of premium amortized.

If the bond is callable at a date earlier than its maturity date, the taxpayer's yield is computed, using the method described above, to such earlier call date on the assumption that the bond will be called at the call price. If the yield is lower, resulting in lower amortization deductions, then amortization must be computed on the basis of such lower yield. If the bond is not called, amortization for subsequent accrual periods is computed as if the bond had been issued on the call date for the call price, and yield for these subsequent periods is computed and used to determine amortization for such subsequent periods.

Note: Section 171(b) retains the provision that in no case is the bond premium to include any amount attributable to any conversion features of the bond. Therefore, in the case of a convertible bond market interest rates for the type and quality of bond involved must be determined and applied to discount future payments due. Any excess of the aggregate present values of such payments is presumably attributable to the conversion features and the taxpayer's basis must be reduced by this amount in computing the amortization allowable.

If the bond described in the example above, which will be assumed to have a fair market value of $55,242.14, had been received by the taxpayer in exchange for property transferred to a wholly owned corporation in a transaction to which §351 applies, and if the basis of the property transferred in A's hands were $58,000, then, for purposes of §171, the basis of the bond cannot exceed $55,242.14.

[11] A DI's yield to maturity is the rate of interest which, when applied to determine the present values of all payments due under the DI, produces an amount equal to the DI's issue price. *See* Prop. Regs. §1.1272-1(f). When applied to a bond purchased for a premium, the taxpayer's yield is the rate of interest which when applied to determine the present values of all payments due produces an amount equal to the purchase price paid for the bond.

II. Short-Term Obligations

A. *Background*

Under §1271, as in effect under pre-1986 TRA law, rules were provided for taking into account OID on the redemption or disposition of a DI issued with the intention to call it before maturity. Also, rules were provided for the taking into account of OID on DIs other than short-term DIs, defined as DIs with a maturity date no more than one year from the date of issue.[12] While §1271(a)(3) provided rules for the taking into account of acquisition discount on short-term government obligations, there was no statutory rule for the taking into account of OID on short-term non-government obligations where it was not required to be taken into account currently under the provisions of §§1281-1283. For example, in the case of a typical certificate of deposit held by a cash basis taxpayer, the portion of the amount received on redemption which had to be reported as interest was determined under general principles of tax law.[13] In this case, all of the gain is treated as interest where the certificate is held to maturity. However, where a certificate is sold, some of the gain may be attributable to a decline in interest rates, and this should be treated as capital gain. Under Prop. Regs. §1.1271-3(b), applicable to short-term non-government obligations issued on or after July 18, 1984 (effective date of the 1984 TRA), the IRS takes the position that any gain realized on disposition is treated as ordinary income to the extent it does not exceed the DI's ratable share of OID. An election to compute accrued OID on a constant interest basis, compounding daily, is provided.[14]

These proposed regulations also permit the portion of gain from the disposition of a short-term government obligation attributable to acquisition discount and treated as ordinary income under §1271(a)(3) to be computed on either a ratable or constant interest basis.[15]

Note that short-term obligations may have either acquisition discount or OID. The tax consequences are the same. Such government obligations as T-bills will usually have acquisition discount since they will not be acquired on original issue. In the case of DIs other than short-term obligations, OID is the excess of the stated redemption price at maturity over the DI's issue price. The stated redemption price at maturity is, generally, all payments due under the instrument other than qualified periodic interest.[16] However, in the case of a short-term obligation, no payments of interest are treated as qualified periodic interest payments.[17] Thus, where a short-term obligation is acquired, either at original issue or from a holder for $90 and it is redeemable at maturity for $100, there is $10 of discount (acquisition or original, depending on the circumstances).

Under pre-1986 TRA §1271(a)(3), a short-term government obligation was defined as an obligation of the U.S.

[12] §1272(a)(2)(C).
[13] *See U.S. v. Midland Ross Corporation*, 381 U.S. 54 (1965).
[14] Prop. Regs. §1.1271-3(b)(4).
[15] Prop. Regs. §1.1271-3(a)(3) and (4).
[16] Prop. Regs. §1.1273-1(b)(1).
[17] Prop. Regs. §1.1273-1(b)(1)(ii)(D).

or any of its possessions, a State or any political subdivision thereof, or of the District of Columbia issued on a discount basis and payable without interest at a fixed maturity date not more than one year from the date of issue. This described the T-bill and some State obligations. However, a number of government short-term obligations may be issued at par but be subsequently acquired at a discount, and some may provide for payment(s) of interest before maturity. There seems to be no reason not to apply the §1271(a)(3) rules to these obligations as well, with modifications where necessary.

The rules of §1272 (relating to the accrual and current inclusion in income by both cash and accrual basis taxpayers of OID) do not apply to, *inter alia,* short-term obligations.[18] Interest deductions by the issuer of an OID instrument are allowed under §163(e) which, generally, permits the issuer to deduct the amounts includible under §1272 by the holder. Under general tax law principles, no deduction for interest by a cash basis issuer of a short-term DI is allowed until such interest is paid. This rule applies whether or not the interest is in the form of OID. Congress decided that this principle should be embodied in a Code provision since there appeared to be some uncertainty about it.

The Act also amended §1281 (requiring certain taxpayers to include in income currently acquisition discount or OID on short-term obligations held by them) to make it clear that this requirement extends not only to discount but also to any stated interest. Section 1281(b)(1), enumerating the short-term obligations to which §1281 applies, was also amended to make it clear that included are any obligations which are stripped bonds or stripped coupons held by the person who stripped the bonds or coupons.

B. Detailed Analysis

The following is a discussion of the technical corrections made by Act §1803(a)(1), (2), (3), (4) and (7) to provisions of the 1984 TRA.

Section §1271(a)(4)(A), as added by Act §1803(a)(1), provides that on the sale or exchange of a short-term non-government obligation, any gain realized is ordinary income to the extent of the ratable share of OID. Such ratable share is total OID multiplied by the following fraction: the number of days the obligation was held by the taxpayer *over* number of days after the date of original issue up to and including the maturity date. §1271(a)(4)(C).

Under §1271(a)(4)(D), the taxpayer may elect to compute such ratable share on a constant interest or economic accrual basis, using daily compounding. The yield to maturity based on the original issue price is applied to compute the daily amount of OID accruing, and as such interest is accrued it is added to the issue price and the holder's basis under rules similar to those of §1272.

Section 1271(a)(3) is amended to grant an election to accrue the taxpayer's ratable share of acquisition discount on the disposition of a short-term government obligation on a constant interest basis, using daily compounding.[19]

Note: Where a short-term obligation with OID or acquisition discount is disposed of before maturity, accrued discount computed on a constant interest basis will always be less than if computed on a straight line or ratable basis. Under the former method, the instrument's yield to maturity is applied to its issue price as adjusted for each daily accrual period.

The definition of short-term government obligation provided by §1271(a)(3)(B) is amended by Act §1803(a)(3). As amended, the term means any obligation of the U.S. or its possessions, or of a State or any political subdivision thereof or of the District of Columbia (unchanged) "which has a fixed maturity date not more than one year from the date of issue." The term does not include any tax exempt obligation. Thus, the term no longer is restricted to a DI issued on a discount basis and payable without interest at a fixed maturity date as under pre-1986 TRA law. It applies to any government short-term DI acquired at discount whether or not interest is payable before maturity.

Section 163(e)(2) is amended to add subparagraph (C) providing that a cash method obligor of a short-term DI may deduct any OID or other interest payable only when paid. Act §1803(a)(4).

Section 1281(b)(1) is amended adding new subparagraph (F) which includes as a short-term obligation any obligation which is a stripped coupon or bond held by the stripper or any person whose basis is determined with reference to the stripper's basis. Act §1803(a)(7).

The effective date for all of the above amendments relating to short-term obligations is the general effective date for technical corrections to the 1984 TRA. Thus, the amended statutory provisions apply as if enacted by such Act.

In addition to the above described amendments, Act §1803(a)(8) amended the provisions of §§1281 and 1282.

The general rule of §1281(a) is amended to provide that in addition to current inclusion in income of discount on certain short-term obligations, there is also includible any interest payable on the obligation as it accrues (other than interest taken into account in determining the amount of the acquisition discount. This current inclusion rule applies to all accrual basis taxpayers and certain cash basis taxpayers which Congress concluded in the 1984 provisions should be treated as if they were accrual basis taxpayers. The same effective date applies to the amendments of §1282(a) (deferring deductions for interest on debt incurred to acquire or carry the short-term obligations subject to §1281 current inclusion) which make its provisions consistent with the above described amendment to §1281(a).

The amendments made to §§1281 and 1282 apply to obligations acquired after September 27, 1985.[20]

[18] §1272(a)(2)(C).

[19] §1271(a)(3)(E), as added by Act §1803(a)(2).

[20] Act §1803(a)(8)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

III. Market Discount Bonds

A. Background

Sections 1276-1278 enacted by the 1984 TRA required for the first time (consistent with the general view of Congress that the Code provisions relating to interest should more nearly reflect the time value of money), that market discount be treated as interest. Market discount arises where the stated redemption price at maturity of a DI exceeds its basis immediately after acquisition.[21] Thus, where a bond redeemable at maturity for $10,000 is acquired for a price of $9,000, there is $1,000 of market discount. Where the bond has OID, the stated redemption price at maturity is treated as being equal to its revised issue price.[22] This term is defined as the DI's issue price plus all amounts includible in the income of any holders (under §1272) without regard to any reductions under §1272(a)(6) or (b)(4) by reason of premium paid.[23] Under the general rule of §1276(a), where the holder of a market discount bond disposes of it, any gain is treated as ordinary interest income to the extent of market discount accrued while the bond was held. Accrual is computed either on a ratable, straight line or constant interest basis.[24] Disposition of a bond includes not only a sale or exchange, but any transfer whether or not taxable. Where the disposition is other than a sale or exchange or involuntary conversion, the bond is deemed disposed of for its fair market value.[25]

Special rules are provided for dispositions in nonrecognition transactions. For purposes of triggering recognition of accrued discount, rules similar to those of §1245(b) are to be applied.[26] Thus, where the bond is transferred to a controlled corporation by a shareholder in a §351 transaction, the disposition, even if the fair market value of the bond exceeds the transferor's basis, did not, under pre-1986 law, trigger recognition of accrued discount under §1276(a).[27] In any nonrecognition transaction in which, under the above rules, recognition of discount was deferred, where the basis of the transferred bond in the transferee's hands was determined with reference to its basis in the transferor's hands ("transferred basis property"), the transferee was treated as having acquired the bond on the same date as did the transferor for an amount equal to the transferor's basis. Thus, where a bond redeemable for $10,000 which the transferor acquired for $8,000 and which, at the time of transfer, had a fair market value of $9,000 is transferred to a controlled corporation in exchange for stock or securities of the corporation, the corporation, which under §362(a) takes a basis in the bond equal to its basis in the hands of the transferor (increased by any gain recognized by the transferor). The transferee is then deemed to have acquired the bond for $8,000 on the same date it was acquired by the transferor. The bond will, therefore, have $1,000 of accrued market discount. If the transferor received a newly issued bond in the exchange with a redemption price at maturity of $10,000, the new bond would have a basis in his hands of $8,000 (under §358) and, hence, there would be market discount of $2,000. If the corporation sells the bond for $9,000, the $1,000 of gain is market discount. The transferor must accrue market discount on the newly issued bond. Thus, the market discount rules cannot be circumvented. However, if the corporation issued stock with a fair market value of $10,000, the market discount rules do not apply to the stock. If the stock is sold, the $2,000 of gain is all capital gain.

The Committee Reports relating to these provisions stated that (1) Congress did not intend to create market discount on the transfer of appreciated property in exchange for a security in a §351 exchange. Further, it was not intended to permit taxpayers to circumvent the market discount provisions by transferring a bond with accrued market discount in a §351 exchange, adding "in that case it may be appropriate to tax the accrued market discount to the transferor (regardless of whether the transferor received stock or securities in the exchange)."[28]

Under the effective date provisions of the 1984 TRA, the market discount provisions were inapplicable to bonds issued on or before July 18, 1984. Where such a pre-enactment bond is transferred after that date in exchange for a new bond in a §351 exchange, and the redemption price of the new bond exceeds the taxpayer's basis in the pre-enactment bond exchanged, there will arise market discount even though the taxpayer's investment position has not changed.

One further problem that needed to be addressed was how partial principal payments should be treated under the market discount rules.

B. Detailed Description of Amendments and Analysis

Section 276(d)(1)(C), as added by Act §1803(a)(5), provides that "paragraph (3) of section 1245(b) shall be applied as if it did not contain a reference to section 351." Thus, where a market discount bond is transferred in a §351 transaction, and the fair market value of the bond exceeds the transferor's basis, the transferor must recognize as ordinary income the accrued discount to the extent of such excess. Such recognized gain is added to the basis of the bond in the transferee's hands.[29] If the stated redemption price of the bond exceeds the transferee's basis immediately after acquisition, then the bond will constitute a market discount bond in the hands of the transferee.[30]

New §1278(a)(1)(C)(i) provides that, except as otherwise provided in the subparagraph or in regulations, the term "market discount bond" shall not include any bond acquired by a taxpayer at its original issue.[31]

There are however, two major exceptions to this general rule provided by §278(a)(1)(C)(ii) and (iii).

Where a bond is acquired at original issue by an underwriter or other broker/dealer wholesaler for sale to

[21] §1278(a)(2)(A).
[22] §1278(a)(2)(B).
[23] §1278(a)(4).
[24] §1276(b).
[25] §1276(a)(2).
[26] §1276(c)(1).
[27] *See* §1245(b)(3).

[28] General Explanation of the Revenue provisions of the Tax Reform Act of 1984, Joint Committee on Taxation, December 31, 1984 at 96.
[29] *See* H.R. Rep. No. 426, 99th Cong, 1st Sess. at 884 (1985) ("House Report").
[30] *Id.*
[31] Act §1803(a)(6).

the public, it is normally acquired at a price less than what is defined as the bond's "issue price" under §1273(b)(3) (initial offering price to the public (excluding bond houses and brokers)). In such a case, where the taxpayer's basis is determined under §1012 and is less than the bond's issue price, the general rule of §1278(a)(1)(C)(i) does not apply,[32] and the bond may be a market discount bond in the underwriter's or broker's hands.

Where a bond is newly issued in a reorganization (within the meaning of §368(a)(1)) in exchange for another bond having market discount, the general rule does not apply to the newly issued bond. This exception does not apply, however, if such other bond was issued on or before July 18, 1984 and if the newly issued bond has the same term and interest rate as the bond exchanged.[33]

The House Report at 884 states that this rule is intended to prevent the holder of a market discount bond from eliminating the taint of unaccrued market discount by swapping the bond for a new bond (*e.g.*, in a recapitalization).

Finally, §1278(a)(1)(C)(iv) provides that for purposes of the general rule of §1278(a)(1)(C)(i), if the adjusted basis of any bond in the hands of the taxpayer is determined by reference to its basis in the hands of a person who acquired the bond at original issue, the bond is treated as if acquired by the taxpayer at original issue. Thus, if a taxpayer holds a DI with an issue price of $8,000 and a stated redemption price of $10,000 and transfers the DI to a controlled corporation in a §351 transaction, the transferee's basis will equal the issue price plus any OID included in the income of the transferor to the time of transfer. Assume that $500 has been so included. The corporation will be treated as holding a DI newly issued for $8,500 with a redemption price of $10,000. It will include the $1,500 of OID in income currently under §1272. Without this rule, the bond might be treated as a market discount bond, and no current inclusion of the discount in income would be required.

Act §1803(a)(13)(A), applicable to obligations acquired after October 22, 1986, amends §1276(a) by adding new paragraph (3) (redesignating former paragraph (3) as (4)) to provide a special rule for bonds with partial principal payments.

Any partial principal payment on a market discount bond is to be included in gross income as ordinary income to the extent the payment does not exceed the accrued market discount of such bond.[34] Where this provision has been applied to a partial payment of principal, the amount of accrued market discount is reduced by the amount included in gross income.[35]

In a related amendment, §1276(b) (relating to the methods for accruing market discount) is amended by adding a new paragraph at the end thereof providing that in the case of a bond whose principal amount may be paid in two or more payments, the amount of accrued market discount is to be determined as provided in regulations.

Note: These amendments appear to be related to debt instruments issued by Real Estate Mortgage Investment Conduits (*See* Chapter 42, *infra*) but also cover other DIs providing for payments of principal in installments before maturity. How the regulations will deal with this problem remains to be seen.

Act §1803(a)(13)(B), effective after October 22, 1986, amends §1286(b)(1) (relating to the tax consequences of stripping a bond or coupon). Under pre-1986 TRA law, a person stripping a bond or coupon must include in gross income an amount equal to the sum of (i) interest accrued on the bond while held by the stripper and before the bond or coupon was disposed of (to the extent such interest was not already included in gross income), and (ii) any accrued market discount determined as of the time the bond or coupon was disposed of (to the extent such market discount has not already been included in gross income).[36] The amendment corrects an obvious oversight made in drafting the provisions of §1286. A clerical conforming amendment is made to §1286(b)(2).

IV. Technical and Clerical Amendments

Act §1803(a), contains a number of technical and clerical amendments which were required to clarify or correct errors and oversights. Some of these were part of the effective date rules contained in the Tax Reform Act of 1984; others occurred in enacting P.L. 98-612 and P.L. 99-121. P.L. 98-612, referred to as transitional by Congress, was intended to alleviate what were perceived as unintended hardships resulting from the rules enacted by the 1984 TRA relating to the imputation of interest. It took the form of amendments to §44(b) of the 1984 TRA which provided effective dates for that Act's amendments to §483 and §§1271-1286. Due to the circumstances under which the Act was drafted, numerous technical and clerical errors were made. Also, the provisions of 1984 TRA §44 contained a number of technical or clerical errors. The technical corrections to be outlined below are addressed to both Acts. The most significant of these corrections will be explained in some detail below. Others will be set forth in essentially the language of the correcting Act since an extended discussion of the Code provisions whose effective dates are clarified are beyond the scope of this chapter.

A. Transfers of Land Between Related Parties

Act §1803(a)(9) makes it clear that in the case of any pre-July 1, 1985 sale or exchange of land between related persons to which §483(f) applies, the discount rate of interest (for imputation purposes) is 6% compounded semiannually. This was unclear under the so-called "transition rules" of P.L. 98-612.

B. "Clarification" of Application of Section 1273(b)(3)(B)

Section 1273(b) (relating to the determination of the "issue price" of a DI) provides, generally, that where a DI

[32] §1278(a)(1)(C)(ii).
[33] §1278(a)(1)(C)(iii).
[34] §1276(a)(3)(A).
[35] §1276(a)(3)(B).
[36] §1286(b)(1)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

is issued in exchange for property other than money, the issue price must be determined under §1274. Section 1273(b)(3), before its amendment, provided that in the case of a debt instrument issued for property and which: (1) is part of an issue a portion of which is traded on an established securities market, or (2) is issued for stock or securities traded on such market, the issue price of the DI is the fair market value of such property. This rule is expanded by Act §1803(a)(10) to provide a fair market value issue price where, to the extent provided by regulations, the DI is issued for property (other than stock or securities) of a kind regularly traded on an established market. This will, presumably, include commodities, foreign currencies, and perhaps some other types of fungible goods.

C. Clerical Amendments

Section 1274(c)(4)(A) (providing one of the exceptions to the general rule that §1274 applies to any DI issued for untraded property) is amended to change "for less than $1,000,000" to "for $1,000,000 or less." [37]

Section 483(d), before the 1986 TRA, provided that §483 does not apply to any DI to which §1272 applies. This is a somewhat awkwardly phrased exception. Section 1272 provides the rules for determining the amount of OID currently includible in income by the holder of a DI. What obviously was intended was to except from the interest imputation provisions of §483, DIs, whose issue price is determined under §1273(b) (*i.e.*, DIs issued for cash or traded property) and DIs to which §1274 applies (since §1274, in effect, preempts §483 in the case of DIs issued for untraded property unless specifically excepted by §1274(c)(3). Where one of these exceptions applies, then §483 may be applied (unless one of the exceptions enumerated in §483(d) applies). Act §1803(a)(14)(B) amends §483(d)(1) to strike out "any DI to which section 1272 applies," and to substitute "any debt instrument for which an issue price is determined under section 1273(b) (other than paragraph (4) thereof) or section 1274." Section 1273(b)(4) provides that where a DI is not issued for money and is not subject to §1274, its stated redemption price at maturity is its issue price. Thus, a DI whose issue price is determined under §1273(b)(4) is subject to §483.

D. Amendments Related to Section 44 of the Tax Reform Act of 1984

As noted above, 1984 TRA §44 generally provided effective dates for the OID/imputed interest amendments made by that Act. Act §1803(b) makes a number of technical and clerical corrections to these provisions. They clarify that the "transitional" rules of P.L. 98-612 apply only to debt instruments issued after December 31, 1984 and before July 1, 1985. They clarify that paragraphs (5), (6) and (7) of §44 as amended by the 1984 TRA (relating to assumptions of debt instruments and applicable only to assumptions before July 1, 1985) apply only to sales or exchanges to which §1274 or §483 (as amended by 1984 TRA §41(a)) apply. Thus, these assumption rules do not apply to sales or exchanges before January 1, 1985, and apply to pre-July 1, 1985 sales and exchanges only if they are subject to either §1274 or §483 as amended by the 1984 Act.

Section 44(b)(3) of the 1984 TRA, as originally enacted, contained the words "and before January 1, 1985" which seem to have been erroneously included since they make little sense in the context. Act §1803(b)(2) strikes out this phrase wherever it occurs in 1984 TRA §44(b)(3).

Additional technical or clerical amendments to 1984 TRA §44(b) and (g) are provided by Act §1803(b)(3), (4) and (5) as follows:

(3) Exception for Binding Contracts - Subparagraph (B) of §44(b)(3) of the Tax Reform Act of 1984 is amended to read as follows:

> "(B) Exception for Binding Contracts. - "(i) Subparagraph (A)(i)(I) shall not apply to any sale or exchange pursuant to a written contract which was binding on March 1, 1984, and at all times thereafter before the sale or exchange.
>
> "(ii) Subparagraph (A)(i)(II) shall not apply to any sale or exchange pursuant to a written contract which was binding on June 8, 1984, and at all times thereafter before the sale or exchange."

(4) Clerical Amendment - Clause (ii) of §44(b)(6)(B) of the Tax Reform Act of 1984 (as added by §2 of P.L. 98-612) is amended by striking out "greater than" and inserting in lieu thereof "not greater than."

(5) Clarification of Effective Date for Repeal of Capital Asset Requirement - Subsection (g) of §44 of the Tax Reform Act of 1984 is amended by striking out "before December 31, 1984" and inserting in lieu thereof "on or before December 31, 1984."

V. Amendments Relating to REMIC Interests

The amendments made to §1272(a) by Act §672 relating to interests issued by a Real Estate Mortgage Investment Conduit; (§§860A through G), or a taxable mortgage pool which are treated as debt instruments for all purposes of the Code are fully discussed in Chapter 42, *infra*. The amendments provide the method of computing the amount of the daily portion of OID accruable with respect to such an interest where it can be ascertained at the time of issue that all or a portion of the principal will be paid before maturity.

VI. Below Market Interest Loans

Act §1812(b) contains a number of amendments clarifying various aspects of the provisions of §7872 relating to "below market interest loans."

Section 4941(b) defining "self dealing" for purposes of the Code provisions relating to private foundations, is amended by Act §1812(b)(1) to clarify that the phrase "without interest or other charge" is to be applied without regard to the provisions of §7872. In other words, whatever interest may be imputed under §7872 is not taken into account in determining whether the transaction constitutes an act of self dealing.

[37] Act §1803(a)(14)(A).

Section 7872(f)(9) is amended by Act §1812(b)(2) to clarify that no withholding under chapter 24 is required with respect to any amount treated as transferred or retransferred under §7872(a) or any amount treated as received under §7872(b).

The definition of "demand loan" set forth in §7872(f)(5) is reworded by the amendment made by Act §1812(b)(3). The second sentence, as amended, reads: "Such term also includes (for purposes other than determining the applicable Federal rate under paragraph (2)) any loan if the benefits of the interest arrangements of such loan are not transferrable and are not conditioned on the future performance of services by an individual." Act §1812(b)(3) also adds a third sentence to §7872(f)(5): "To the extent provided in regulations, such term also includes any loan with an indefinite maturity."

Act §1812(b)(4) amends §7872(f)(2) (defining applicable Federal rate) to add the erroneously omitted words "compounded semiannually" to subparagraph (B) (which refers to the short-term rate) at the end thereof. All applicable federal rates are expressed in terms of semiannual compounding - *See* §1274(d) defining "applicable Federal rate."

Act §1812(b)(5) exempts from the provisions of §7872 obligations issued by the State of Israel if such obligations are payable in U.S. dollars and bear interest at an annual rate of at least 4%. Presumably the 4% referred to is simple interest.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 32

REVISED ALTERNATIVE MINIMUM TAX FOR NON-CORPORATE TAXPAYERS

Javed A. Khokhar, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

The revision of the alternative minimum tax rules by the Tax Reform Act of 1986 is the latest in many rounds of legislative amendments dating back to 1969. To put the 1986 changes in perspective, a review of the history of AMT is necessary.

A. The Tax Reform Act of 1969

The minimum tax stems from tax reform studies first undertaken by the Treasury Department during the Johnson administration. The Treasury proposals [1] evidenced a concern that the tax laws permitted some individuals with large incomes to pay little or no tax, while other individuals with far less income were required to pay a higher percentage of their income in tax, and persons with low and modest incomes paid a significant share of their income in tax. It was felt that this undermining of the progressive rate structure and unfair allocation of the tax burden was caused by the existence of a favored tax status afforded certain types of income.

The Treasury proposals isolated four tax preferences that it felt contributed most significantly to the above-mentioned disparity in treatment among individuals (corporations were not subject to these proposals). These were the §1202 net long-term capital gains exclusion (with the alternative of taxing the entire gain at a 25% rate), tax-exempt interest received on state and local government bonds, the exclusion resulting from percentage depletion in excess of the capital invested in the ownership of minerals or other natural resources, and the appreciation element in charitable gifts of appreciated property to the extent deductible under §170.

Treasury then proposed a graduated minimum tax rate (7-35%) to be applied to an expanded income base. The income base was to consist of taxable income plus the above-mentioned preferences. If this tax was higher than the tax computed under the normal rates, it became the final tax liability.

In computing the minimum tax base, the individual was to be allowed all of his itemized deductions or a special $10,000 standard deduction if more advantageous. The proposals, however, also introduced a new concept called "allocation of deductions." This approach required an individual to allocate his non-business expense deductions between taxable and exempt income, and allowed such deductions only to the extent allocable to taxable income. This concept generally was aimed at preventing use of preference-related deductions against otherwise taxable income.

The Treasury studies recommended that certain individual nonbusiness itemized deductions [2] (that is, most itemized deductions) be allocated between income and preference income, with only the part allocable to taxable income being permitted as deductions in computing tax. Here, as in the minimum tax computation, there was relief for those with minor amounts of preferences; an individual with $5,000 or less of preferences was not subject to the allocation.

The Treasury studies served as the basis for the subsequent submission of proposals to Congress by the Nixon Administration and the ultimate enactment of an add-on [3] minimum tax by the Tax Reform Act of 1969 (P.L. 91-172).

The Tax Reform Act of 1969 (P.L. 91-172) added §56, 57, and 58 to the Code.[4] Under these provisions, effective for taxable years ending after December 31, 1969, both individuals and corporations were subjected to a minimum tax which was in addition to the regular tax. The minimum tax was calculated by applying a 10% rate to the minimum tax base. The minimum tax base was computed by adding together certain tax preferences and subtracting therefrom the regular federal income taxes paid by the taxpayer and an exemption amount of $30,000. Spouses who filed separate returns and each had tax preferences were required to split the $30,000 exemption amount.

The tax preference items included in the minimum tax base were:

(1) Excess investment interest. This item of tax preference was equal to the excess of investment interest expense over net investment income. It applied only to individuals, subchapter S corporations, and personal holding companies, and then only until 1972.

---

[1] *Treasury Tax Reform Studies and Proposals (Part 2)* pp. 132 and 142 (1969).

[2] The nonbusiness deductions to be so allocated were interest, taxes, casualty losses, charitable contributions, medical expenses, and cooperative housing expenses.

[3] An add-on minimum tax is a tax which is in addition to taxpayer's regular tax liability.

[4] Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(2) Accelerated depreciation on personal property subject to a net lease.

(3) Accelerated depreciation on real property.

(4) Amortization of rehabilitation expenditures.

(5) Amortization of certified pollution control facilities.

(6) Amortization of railroad rolling stock.

(7) The bargain element in stock options.

(8) Bad debt deductions of financial institutions. (This basically was a corporate preference item).

(9) Depletion deduction taken for the year over the cost of the property reduced for depletion taken in prior years.

(10) Capital gains. For noncorporate taxpayers, this preference was equal to one-half of the net long-term capital gain, to the extent it exceeded the net short-term capital loss.[5]

Because the minimum tax was not achieving its purpose, pressure was put on the Congress to tighten this provision to insure that the original objective was in fact achieved. Consequently, a considerable tightening of the minimum tax rules took place in the Tax Reform Act of 1976.

B. The Tax Reform Act of 1976 (P.L. 94-455)

The Tax Reform Act of 1976 (P.L. 94-455) strengthened the minimum tax provisions by increasing the effective tax rate and by adding some new items of tax preference.

The minimum tax rate was increased from 10 to 15%. For noncorporate taxpayers the exemption amount was reduced from $30,000 plus the regular income taxes to the greater of: (i) $10,000 or (ii) one-half of the regular income tax for the year.[6]

For noncorporate taxpayers the following new items of tax preference were added:

(1) Excess itemized deductions. This item of tax preference was equal to the taxpayer's itemized deductions (other than the deductions for medical expenses and casualty losses) in excess of 60% of adjusted gross income (reduced by the deductions for medical expenses and casualty losses).

(2) Intangible drilling costs. The excess of deductible intangible drilling costs paid or incurred in connection with productive oil and gas wells over the amount that would have been deductible if such costs had been capitalized and either amortized over a 10-year period or deducted over the lives of the wells as cost depletion.

(3) Accelerated depreciation on personal property. The tax preference item for accelerated depreciation on personal property subject to a net lease was expanded to cover all leased personal property.

For corporate taxpayers, no new tax preferences were added.

The changes made by the Tax Reform Act of 1976 were generally effective for taxable years beginning after December 31, 1975.

C. Revenue Act of 1978

The Revenue Act of 1978 (P.L. 95-600) restructured the minimum tax provisions applicable to noncorporate taxpayers for taxable years beginning after 1978. The add-on minimum tax, as in effect in 1978, no longer applied to the capital gains and the excess itemized deductions preference items. These two items of tax preference instead formed part of a new alternative minimum tax which took effect in taxable years beginning after 1978. Thus, for 1979 and later years, noncorporate taxpayers were subject to two distinct types of minimum tax: under §56, they were subject to an add-on minimum tax, and under §55 (enacted as part of the 1978 Act), they were subject to an alternative minimum tax.

1. The Add-on Minimum Tax

The add-on minimum tax, as in effect for taxable years beginning after 1978, was levied on the "minimum tax base" of a noncorporate taxpayer [7] at the rate of 15%. The "minimum tax base" was computed by adding together the items of tax preference for the taxable year and subtracting therefrom the greater of:

(a) the annual $10,000 exemption; or

(b) the regular tax deduction for the taxable year.

A noncorporate taxpayer's tax preferences subject to the add-on minimum tax included the following:[8]

(a) Depreciation on real property in excess of straight line depreciation;

(b) Depreciation on personal property subject to a lease in excess of straight line depreciation;

(c) Amortization of certified pollution control facilities (*i.e.*, the excess of 60-month amortization over depreciation otherwise allowable under §167;

(d) Amortization of railroad rolling stock (*i.e.*, the excess of 60-month amortization over depreciation otherwise allowable under §167);

(e) The bargain element of a qualified stock option (as defined in §422(b));

(f) Amortization of child care facilities (*i.e.*, the excess of 60-month amortization over depreciation otherwise allowable under §167);

(g) Percentage depletion in excess of the adjusted basis of the property; and

(h) Intangible drilling costs on oil, gas and geothermal wells in excess of net income from oil, gas, and geothermal wells.

[5] In the case of corporations, this item of preference was the excess of net long-term capital gain over net short-term capital loss multiplied by a ratio, the denominator of which was the regular corporate tax rate (*i.e.*, 48%) and the numerator of which was the regular corporate rate minus the capital gains rate applicable to corporations.

[6] For corporate taxpayers, the exemption amount was reduced to the greater of $10,000 or the full amount of regular tax.

[7] As in taxable years before the effective date of the Tax Reform Act of 1978, corporate taxpayers remained subject to the §56 add-on minimum tax.

[8] *See* §57(a), as in effect before its amendment by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The "regular tax deduction" for noncorporate taxpayers was defined in §56(c) to mean one-half [9] of all Chapter 1 taxes for the year other than: (i) the minimum tax; (ii) the penalty tax on premature distributions from HR-10 plans (§72(m)(5)(B)); (iii) the tax on lump-sum distributions from tax-qualified pension plans (§402(e)); and (iv) the tax on premature distributions from individual retirement accounts (§408(f)) — reduced by various nonrefundable credits. These credits included: (i) the credit for tax withheld from a nonresident alien's income; (ii) the foreign tax credit; (iii) the credit for elderly; (iv) the investment tax credit; (v) the WIN credit; (vi) the political contributions credit; (vii) the general tax credit; (viii) the credit for the purchase of a new residence; (ix) the child care credit; (x) the targeted jobs tax credit; (xi) the residential energy credit; (xii) the alternative fuel production credit; (xiii) the alcohol fuels credit; and (xiv) the credit for increasing research activities.

2. Alternative Minimum Tax

The Revenue Act of 1978 added a new §55 to the Code. Section 55 imposed an alternative minimum tax on noncorporate [10] taxpayers' "alternative minimum taxable income" to the extent it produced a higher tax than the taxpayers' regular tax liability (as increased by §56 add-on minimum tax). "Alternative minimum taxable income" was determined by adding back to the taxable income of the taxpayer the preference items for the adjusted itemized deductions and the capital gains deduction for the taxable year.[11]

Note: In computing "alternative minimum taxable income," amounts otherwise included in income pursuant to §86 (as a result of the income tax credit for alcohol fuels allowable in the prior taxable year) or §667 (as a result of any accumulation distributions from a trust) were excluded.[12]

An individual taxpayer's preference for adjusted itemized deductions was equal to the taxpayer's itemized deductions (other than the deductions for medical expenses, casualty losses, state, local or foreign taxes, and estate taxes) in excess of 60% of adjusted gross income (reduced by the deductions for medical expenses, casualty losses, state, local, or foreign taxes, and estate taxes).[13] For estates and trusts, however, certain additional adjustments were necessary to arrive at the preference amount for adjusted itemized deductions.[14] In the case of individuals who did not itemize deductions, the zero bracket amount was treated as the deduction allowed.[15]

The alternative minimum tax was imposed according to the following rate table:

Alternative Minimum Taxable Income	*Tax*
Under $20,000	0
$20,000—$60,000	10%
$60,000—$100,000	$4000 plus 20% of the excess over $60,000
Over $100,000	$12,000 plus 25% of the excess over $100,000

For taxable years beginning after 1981, the Economic Recovery Tax Act of 1981 (P.L. 97-34) reduced the top alternative minimum tax rate to 20% on all alternative minimum taxable income exceeding $60,000.

For all practical purposes, the amount calculated under the above rate schedule represented the taxpayer's total tax liability (provided it exceeded the "regular tax" for the taxable year). Technically, however, the alternative minimum tax was equal to the gross alternative minimum tax calculated under the above schedule, minus the "regular tax" for the taxable year.

The term "regular tax" encompassed all taxes imposed by Chapter 1 (including §56 add-on minimum tax) for the taxable year other than: (i) the §72(m)(5)(B) penalty tax on premature distributions from HR-10 plans; (ii) the §402(e) tax on lump-sum distributions from tax-qualified pension plans; (iii) the §408(f) tax on premature distribution from individual retirement accounts; (iv) the §409(c) tax on early redemption of retirement bonds; and (v) the §667(b) tax on accumulated distributions from trusts — reduced by the sum of nonrefundable credits.[16]

Certain nonrefundable credits (other than the foreign tax credit) were allowable against the alternative minimum tax but only to the extent such tax was not attributable to the net capital gain or adjusted itemized deductions.[17] In addition, the investment tax credit, the WIN credit, and the targeted jobs credit were allowable against the alternative minimum tax only to the extent such credits were attributable to an active trade or business.[18] Any disallowed credits, however, increased the amount allowed as a carry-over. The foreign tax credit was allowed in full against the alternative minimum tax. In general, the foreign tax credit was computed under the regular foreign tax credit rules of §§901-908. The foreign tax credit limitation of §904(a), however, was computed separately for purposes of the alternative minimum tax. Consequently, the amount of foreign tax credit allowed against the alternative minimum tax was limited to the same proportion of the gross alternative minimum tax as the taxpayer's alternative minimum taxable income from foreign sources bore to his entire minimum taxable income from worldwide sources.[19]

[9] For corporate taxpayers, the full amount of Chapter 1 taxes is taken into account for computing the "regular tax deduction."

[10] The alternative minimum tax enacted by the Tax Reform Act of 1978 did not apply to corporate taxpayers.

[11] Both the adjusted itemized deductions and the capital gains deduction preferences were excluded from treatment as items of tax preference for purposes of the §56 add-on minimum tax as applied to noncorporate taxpayers.

[12] *See* Code §55(b)(1), as in effect before TEFRA.

[13] *See* pre-TEFRA Code §57(b)(1).

[14] *See* pre-TEFRA Code §57(b)(2).

[15] *See* pre-TEFRA Code §55(b)(3).

[16] *See* pre-TEFRA Code §55(b)(2).

[17] *See* pre-TEFRA Code §55(c)(1). For taxable years beginning prior to 1980, §55(c)(1) did not allow nonrefundable credits (other than the foreign tax credit) to offset the alternative minimum tax. *See* §55(c) prior to its amendment by P.L. 96-603.

[18] *See* pre-TEFRA Code §55(c)(3).

[19] *See* pre-TEFRA Code §55(c)(2)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

D. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)

Expressing its dissatisfaction with the way wealthy individuals continued to avoid paying any taxes through the use of exclusions, deductions, and credits, Congress, in TEFRA, once again revised the minimum tax rules applicable to noncorporate taxpayers.

Effective for taxable years beginning after 1982, TEFRA repealed the §56 add-on minimum tax (as it applied to noncorporate taxpayers) and the §55 alternative minimum tax (as in effect prior to TEFRA) and instead enacted a revised and expanded alternative minimum tax for noncorporate taxpayers.[20]

The Senate Finance Committee Report on H.R. 4961 noted:[21]

> "The committee has amended the present minimum tax provisions applying to individuals with one overriding objective: no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions and credits. Although these provisions provide incentives for worthy goals, they become counter-productive when individuals are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. Therefore, the committee has provided an alternative minimum tax which is intended to insure that, when an individual's ability to pay taxes is measured by a broad-based concept of income, a measure which can be reduced by only a few of the incentive provisions, tax liability is at least a minimum percentage of that broad measure. The only deductions allowed, other than costs of producing income, are for important personal or unavoidable expenditures (housing interest, medical expenses and casualty losses) or for charitable contributions, the deduction of which already is limited to a percentage of adjusted gross income.
>
> The committee's changes in the minimum tax also simplify the taxpayer's computations, since the present law add-on minimum tax is repealed. This change actually provides tax reductions for many middle-income taxpayers who pay a minimum tax on some preference income but also have substantial amounts of non-preference income. By adding all preferences into the base of the alternative minimum tax and focusing the minimum tax on high income individuals, the committee's provision increases tax liability only for income classes of taxpayers with over $100,000 of income."

E. The Tax Reform Act of 1984

The Tax Reform Act of 1984 (P.L. 98-369) made certain technical, not-so-technical, and clarifying amendments to §§55 and 57. In addition, the amendments made by the Act elsewhere (*e.g.*, renumbering and simplication of tax credits, extension of the ACRS recovery period for real estate, etc.) necessitated conforming amendments to the rules governing the computation of alternative minimum tax.

F. Alternative Minimum Tax Before the Tax Reform Act of 1986 [22]

For taxable years beginning before 1987, §55 imposed on individuals, estates, and trusts, an alternative minimum tax equal to the excess of the gross alternative minimum tax (or tentative alternative minimum tax) over the regular tax for the taxable year. Before comparing the gross (or tentative) alternative minimum tax to regular tax, however, certain adjustments were made to the "regular tax" computed under the normal Code rules. Specifically: (i) taxes imposed by §§72(m)(5)(B), 72(q), 402(e), 408(f), 409(c), and 667(b) were disregarded; and (ii) the "regular tax" was reduced by credits allowable under Subparts A, B, and D of Part IV of subchapter A.

The gross alternative minimum tax was determined by applying a flat 20% rate to the taxpayer's "alternative minimum taxable income," less the exemption amount specified in §55(f)(1).

Conceptually, the determination of "alternative minimum taxable income" was a two-step process: alternative minimum tax adjusted gross income was computed by using the regular tax adjusted gross income as the starting point. Alternative minimum tax adjusted gross income was then reduced by certain specified itemized deductions to arrive at alternative minimum taxable income.

Alternative minimum tax adjusted gross income was obtained by making the following adjustments to the regular tax adjusted gross income:

(1) Any amount included in gross income under §87 was excluded;

(2) Any amount included in gross income under §667 was excluded;

(3) The regular net operating loss deduction was replaced by the alternative tax net operating loss deduction as defined in §55(d); and

(4) The sum of items of tax preference deductible in arriving at adjusted gross income was added back.

The items of tax preference required to be added back were defined in §57(a) and included the following:

(1) Exclusion for Dividends. Dividends received by individuals from certain domestic corporations and excluded from gross income under §116 of the Code were an item of tax preference.

(2) ACRS Deductions. For recovery property subject to a lease (other than 19-year real property and low income housing), the excess of the ACRS deduction over the amount that would have been allowed as a deduction had the property been depreciated using a specified longer recovery period under the straight-line method constituted an item of tax preference. For 19-year real property, the

[20] TEFRA §201.

[21] S. Rep. No. 494, Vol. 1, 97th Cong. 2nd Sess. pp. 108-109 (1982).

[22] All references in this Code §are to Code sections as they stood before the enactment of the Tax Reform Act of 1986.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

amount of tax preference was the excess of the ACRS deduction over the amount that would have been allowed had the property been depreciated under the straight-line method.

(3) Accelerated Depreciation. For real property and leased personal property, which was placed in service before 1981 or which was excluded from the application of the ACRS rules, the excess of any allowance for exhaustion, wear and tear, obsolescence, or amortization over the amount that would have been allowable had the taxpayer used the straight-line method for each year of the property's useful life constituted an item of tax preference.

(4) Amortization of Pollution Control Facilities. The excess of the amortization deduction allowable for the year under the 60-month write-off election of §169 for "certified pollution control facilities" over what would otherwise be allowable as a depreciation deduction under §167 was treated as an item of tax preference.

(5) Mining Exploration and Development Costs. The excess of the deduction claimed for mining exploration and development costs under §616(a) or §617 over the amount that would have been deductible had such costs been capitalized and amortized over a 10-year period was treated as an item of tax preference.

(6) Circulation and Research and Development Costs. The preference amount for circulation expenditures was equal to the excess of the allowable deduction under §173 for the taxable year over the amount that would have been allowable had the expenditures been capitalized and amortized over a 3-year period. Similarly, the amount of tax preference for research and development costs was equal to the excess of the allowable deduction under §174 for the taxable year over the amount that would have been allowable had the costs been capitalized and amortized over a 10-year period.

(7) Depletion. The excess of the depletion deduction allowable over the adjusted basis of the property at the end of the year, disregarding the current year's depletion.

(8) Capital Gains. For individual taxpayers, the net capital gain deduction as determined under now-repealed §1202.

(9) Incentive Stock Options. The tax preference for incentive stock options was equal to the excess of the fair market value of a share of stock transferred to the taxpayer pursuant to the exercise of a stock option at the time of exercise over the option price .

(10) The amount of excess intangible drilling and development costs for the taxable year over the taxpayer's net income from oil, gas, and geothermal properties for that taxable year. Excess intangible drilling and development costs were the excess of such costs paid or incurred with respect to productive oil, gas, or geothermal wells that the taxpayer elected to deduct under §263(c) over the amount that would have been allowable for the taxable year if the costs had been capitalized and amortized in accordance with any method provided in §57(d). Section 57(d) prescribed either a 120-month amortization or any method permitted for determining cost depletion.

Once alternative tax adjusted gross income had been obtained, alternative minimum taxable income was computed by deducting the sum of alternative tax itemized deductions from alternative tax adjusted gross income. The alternative tax itemized deductions included: (i) casualty and wagering losses under §§165(c)(3) and 165(d); (ii) medical expenses under §213 (as modified by §55(e)(7); (iii) charitable contributions under §170; (iv) qualified interest as defined in §55(e)(3); and (v) estate taxes under §691(c).

Alternative minimum taxable income was then reduced by the exemption amount to arrive at the minimum tax base. The exemption amount was: (i) $40,000 for a joint return, (ii) $30,000 for a single return, and (iii) $20,000 for a separate return.

The gross (or tentative) alternative minimum tax was computed by applying a flat 20% rate to the alternative minimum tax base. The gross alternative minimum tax was reduced by refundable credits and the foreign tax credit. No nonrefundable tax credits, other than the foreign tax credit, were allowed against the minimum tax. The gross alternative minimum tax (net of credits) was then compared to the regular tax (net of credits). The taxpayer was required to pay the minimum tax if it was greater than the regular tax. Since nonrefundable credits were not allowed against the minimum tax, the taxpayer was allowed a credit carryover to the extent the taxpayer did not derive a tax benefit from such credits due to the imposition of the minimum tax.

G. The Tax Reform Act of 1986

Spurred by a concern that individuals with substantial economic incomes continued to avoid significant tax liability through an aggressive use of tax incentives, the 99th Congress again revamped the alternative minimum tax rules. The House Report on the Tax Reform Act of 1986 observed:

> "With respect to the taxation of individuals, fairness and taxpayer morale have been particularly harmed by the proliferation of tax shelters, whereby individuals with substantial economic incomes in effect purchase tax benefits that are not accompanied by significant economic burdens, and thereby may escape significant tax liability. Although some tax shelters depend upon the availability of tax preferences, many tax shelters exploit inherent structural features of the tax system (e.g. the contrast between allowing current depreciation and interest deductions, on the one hand, and not taxing unrealized appreciation, on the other). An effective minimum tax is necessary to allow the committee to substantially reduce the marginal tax rates applicable to high-income taxpayers without causing an overall percentage tax reduction for this group larger than for the average taxpayer."[23]

II. Overview

Section 701 of the Tax Reform Act of 1986 substantially amended §§55, 56, 57 and 58, and added §§53 and 59.

[23] H.R. Rep. No. 426, 99th Cong. 1st Sess., p. 306 (1985). ("House Report").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The alternative minimum tax rules for individuals (and corporations), therefore, after the 1986 TRA, are contained in §§53, 55, 56, 57, 58 and 59.

For taxable years beginning after December 31, 1986, the amended §55 imposes on noncorporate taxpayers an alternative minimum tax equal to the excess of the "tentative minimum tax" for the taxable year over the "regular tax" for the taxable year. For §55 purposes, "regular tax" continues to have a special meaning: it means the regular tax liability for the taxable year (as defined in §26(b)) computed without regard to any tax imposed under §402(e) and any increase in tax under §47, and reduced by the foreign tax credit allowable under §27(a). The tentative minimum tax for noncorporate taxpayers is equal to 21% of the alternative minimum tax base, reduced by the alternative minimum tax credit. (Corporations pay alternativwe minimum tax at a 20% rate after the TRA.) The alternative minimum tax base is computed by reducing alternative minimum taxable income by the exemption amount.

Section 55(b)(2) defines alternative minimum taxable income as the taxable income of the taxpayer for the taxable year, adjusted in accordance with §§56 and 58 and increased by the amount of the items of tax preference provided in §57.

The foregoing definition of the Alternative Minimum Taxable Income (AMTI) has two clear implications:

First, the computation of AMTI is a computation entirely distinct and apart from the computation of taxable income for regular tax purposes.

Second, AMTI is computed in the same way as taxable income for regular tax purposes but with two types of modifications:

(i) certain items of income and deductions used in the computation of regular taxable income are adjusted as provided in §§56 and 58; and

(ii) certain items of tax preference, as provided in §57, are added back to taxable income (as adjusted under (i) above).

The adjustments required in the computation of AMTI are summarized below.

(a) Depreciation Deductions. For property placed in service after 1986, depreciation deductions are required to be calculated under the Alternative Depreciation System of §168(g) but using 150% declining balance method, switching to straight-line in later years.

(b) Mining Development and Exploration Costs. With respect to each mine or other natural deposit, mining development and exploration costs incurred after December 31, 1986, are required to be capitalized and amortized ratably over a 10-year period.

(c) Long-Term Contracts. For any long-term contract entered into by the taxpayer on or after March 1, 1986, the taxable income from such contract must be determined under the percentage-of-completion method as modified by §460(b).

(d) Net Operating Loss Deduction. In computing the AMTI, the alternative tax net operating loss deduction must be substituted for regular tax net operating loss deduction.

(e) Installment Sales. The installment sales method of accounting is not permitted for alternative minimum tax purposes. Thus, the taxpayer must include in AMTI the entire gain derived from the sale or other disposition of property under the installment method.

(f) Pollution Control Facilities. For certified pollution control facilities placed in service after December 31, 1986, the allowable deduction must be computed under the alternative system of §168(g).

(g) Circulation Expenditures. Circulation expenditures (deductible under §173) incurred after December 31, must be capitalized and amortized over a 3-year period.

(h) Research and Development Expenditures. Research and development expenditures (described in §174(a)) incurred after December 31, 1986, must be capitalized and amortized ratably over a 10-year period.

(i) Gain (or Loss) From the Sale or Exchange of Property. In determining gain (or loss), for AMTI purposes, from the sale or exchange of property with respect to which adjustments have been made as described in paragraphs (a), (b), (f), (g) and (h) above, the adjusted basis of such property will be determined based on the treatment prescribed in those paragraphs.

(j) Itemized Deductions. Taxpayers who do not itemize deductions are not allowed the standard deduction. Taxpayers who itemize deductions are not allowed the following deductions: (i) miscellaneous itemized deductions described in §67(b) (*e.g.*, reimbursed employee business expenses), (ii) state and local tax deduction, and (iii) medical expense deduction up to 10% of adjusted gross income. In addition certain clarifying changes are made with respect to qualified interest deduction.

(k) State and Local Tax Refunds. To the extent no deduction is permitted for state and local taxes in computing AMTI, a refund of such taxes is excluded from gross income.

(l) Farm Losses. In computing AMTI, no deduction for a loss from a tax shelter farm activity is allowed.

(m) Passive Losses. In computing AMTI, no deduction for losses from certain passive activities is allowed. Passive activity losses for AMTI purposes are computed in the same way as for regular tax purposes except that the adjustments described in §56 are taken into account and any deduction which is an item of tax preference under §57 is not taken into account. Also, for AMTI purposes, the phase-in rules of §469(l) do not apply.

After the taxable income of the taxpayer has been recomputed with the adjustments described in the preceding paragraphs, the amount of the items of tax preference is added back to the recomputed taxable income to arrive at AMTI. The items of tax preference for individuals are enumerated below.

(a) Depletion. With respect to each property, the excess of the deduction for depletion allowable under §611 over the adjusted basis of the property at the end of the taxable year.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(b) Intangible Drilling Costs. The amount by which the excess intangible drilling costs of the taxpayer exceed 65% of the taxpayer's net income for the taxable year from oil, gas, or geothermal properties.

(c) Incentive Stock Options. Where a taxpayer is granted an incentive stock option, the amount by which the fair market value of the shares at the time of option exercise exceeds the option price.

(d) Charitable Contributions of Appreciated Property. The amount by which a deduction under §170 would be reduced if all contributed property were taken into account at its adjusted basis.

(e) Tax-Exempt Interest. Tax-exempt interest on private activity bonds issued after August 7, 1986.

(f) Pre-TRA 1986 Accelerated Depreciation and Amortization. For property placed in service before January 1, 1987, the amount which would be treated as an item of tax preference under either §§57(a)(2), 57(a)(3), 57(a)(4) or 57(a)(12), as in effect prior to the enactment of TRA 1986.

Section 59(e) provides a taxpayer with the option of electing, for regular tax purposes, minimum tax treatment for circulation expenditures, research and development expenditures, mining development and exploration costs and intangible drilling costs. That is, the taxpayer may elect, for regular tax purposes, to treat these expenditures and costs as capital expenditures and costs and amortize them ratably over a 10-year period (three years in the case of circulation expenditures). If taxpayer makes this election then, with respect to these expenditures and costs, no adjustments or preference items will result for AMT purposes.

Once AMTI has been computed, it is reduced by the exemption amount to arrive at the alternative minimum tax base. The exemption amount is $40,000 for joint returns, $30,000 for single returns and $20,000 for separate returns. This exemption amount, however, is phased out by 25 cents for each $1 once AMTI reaches certain levels. The phase-out for joint returns begins at $150,000, at $112,500 for single returns and at $75,000 for separate returns.

As previously indicated, for noncorporate taxpayers, the tentative alternative minimum tax is equal to 21% of the alternative minimum tax base. The excess of the tentative alternative minimum tax over the regular tax for the taxable year is the taxpayer's net minimum tax liability.

Note that the only non-refundable credit that is allowed against the alternative minimum tax is the alternative tax foreign tax credit. The alternative tax foreign tax credit, however, may offset tentative minimum tax liability only to the extent of 90% thereof.

Any nonrefundable credit that fails to yield a regular tax benefit in the current taxable year due to the imposition of the alternative minimum tax is available as credit carryover provided a carryover for such credit is permitted under the normal Code rules. The mechanism utilized to accomplish this result is to limit the allowance of the aggregate amount of nonrefundable credits against the regular tax in any given year to the excess of the regular tax over the tentative minimum tax. In other words, to the extent incentive credits do not yield a tax benefit due to the imposition of the minimum tax, they are also disallowed for regular tax purposes thus, resulting automatically in a carryover.

Finally, a feature introduced by the TRA 1986 is the alternative minimum tax credit. This credit, along with the adjustment mechanism utilized in computing AMTI (*see* §§56 and 58), is intended to coordinate the regular tax and the minimum tax systems so that a taxpayer is not disadvantaged by being on the minimum tax system in one year and on the regular tax system in another. The §53 minimum tax credit provides that, if a taxpayer is subject to the minimum tax in any taxable year, that portion of the net minimum tax liability that is attributable to "deferral preferences" may be carried over to subsequent taxable years and utilized against the regular tax on a cumulative basis. The minimum tax credit, however, may not reduce regular tax below tentative AMT in any taxable year.

III. Detailed Analysis

A. Introduction to Revised AMT

The TRA 1986 makes significant changes to the AMT rules. It not only restructures the AMT considerably from a computational standpoint, it also extends the rationale underlying the AMT to new limits. The traditional role of the AMT has been to ensure that all taxpayers pay a minimum amount of tax. The message conveyed by the 1986 Act changes, however, is: all taxpayers will pay a minimum amount of tax and no taxpayer will derive more than a limited amount of benefit from tax incentives. That is not to say that the revised AMT will have a much greater significance than the pre-1986 Act version. On the contrary, certain profound changes elsewhere in the Code might diminish the significance of AMT for individual taxpayers. For instance, due to the Act's enactment of the passive loss limitation and investment interest limitation rules, the AMT base and the regular tax base are likely to coincide for most taxpayers who were in an AMT position prior to 1987. Also, due to a relatively small rate differential between the AMT for noncorporate taxpayers (*i.e.* 21%) and the regular tax (*i.e.,* top marginal rate of 28%) there will be less incentive for taxpayers to use preferences and other tax incentives. Note, however, that, since the passive loss limitation and investment interest limitation rules are phased-in over a 4-year period for regular tax purposes but not for AMT purposes, until 1990, the revised AMT will remain of major concern to individual taxpayers.

To assist the reader in understanding the detailed rules governing the computation of the AMT, some notable features of the revised AMT are discussed below.

The Alternative Minimum Tax (AMT), as revised by the 1986 Act, may be viewed as a back-door enactment of a flat tax system. It is characterized by three elements which render it a credible impersonator of a true flat tax system:

(i) The AMT provides a baseline standard against which each taxpayer must measure his tax liability even though it may not apply to him. In practice, however, the AMT is designed to apply to taxpayers with substantial economic incomes who use tax credits and other tax incen-

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tives [24] to reduce their tax liabilities below a 21% (the minimum tax rate for noncorporate taxpayers) effective rate of tax.[25] The AMT will not apply to taxpayers who do not use tax credits and other tax incentives. The taxpayers in this last category may pay tax at an effective rate above or below 21%, depending on their taxable income levels.

(ii) The AMT provides a single rate of tax, *i.e.*, 21% for noncorporate taxpayers (20% for corporations). It may be argued that this rate of tax is rather high to suit a flat tax system. Remember, however, that, given the revenue needs, the rate of tax in a flat tax system is a direct function of the tax base. Congress could have lowered this rate had it chosen to further broaden the AMT base.

(iii) The AMT applies a single tax rate to a tax base which attempts to define true economic income. Note the emphasis on the word "attempts." The AMT base, under the 1986 Act changes, however, makes a much more serious attempt to define true economic income than the prior version of the AMT. For example, the revised AMT base includes rapid depreciation on all personal property (rather than leased personal property only) and tax-exempt interest. It disallows the use of the completed contract method of accounting and the installment sales method of reporting income. Further, it disallows passive activity losses, tax shelter farm losses, and certain itemized deductions. The AMT base is far from comprehensive, however, because it still includes items that are inconsistent with the definition of true economic income, *e.g.*, the mortgage interest deduction, the state and local income and property tax deductions, the charitable contributions deduction, etc.

Another feature of the revised AMT is that it is a tax system unto itself which is entirely distinct from, and runs parallel to, the regular tax system. In other words, individuals are, after the 1986 TRA, subject to a two-track tax system. Any taxpayer who uses an incentive credit or other incentive item may find that he is obligated to keep two sets of books, one for regular tax purposes and one for AMT purposes, not only in the year of the use but also from year-to-year. For example, if a business taxpayer places an asset in service in 1987 and takes depreciation deductions under the ACRS, it will be advisable for him to maintain two depreciation schedules with respect to the asset, *i.e.*, one under the ACRS and one under the Alternative Depreciation System of §168(g). The schedule under §168(g) is required to compute the taxpayer's tentative AMT from year-to-year until the asset has been completely written off. What is true of depreciation deductions is also true of most other adjustments and preferences, *e.g.*, net operating losses, the completed contract method of accounting, research and development expenditures, mining development and exploration costs, and pre-TRA 1986 accelerated depreciation and amortization.[26] Taxpayers will also be required to keep a running record of the adjusted bases of assets (based on deductions allowed for AMT purposes) to compute the gain or loss to be taken into account in computing the AMTI upon the disposition of such assets. If a taxpayer is subjected to the AMT in any taxable year, he will be obligated to keep account of the minimum tax credit carryovers until the credits are fully absorbed.

Finally, the revised AMT deals with inequities inherent in the pre-TRA version of the AMT. Under pre-1986 TRA law, if a taxpayer was subject to AMT he never got the amount of regular tax benefit from the preferences (giving rise to the AMT) which he would have obtained if those preferences had not received preferential treatment in the first place. For instance, under prior law, if a taxpayer took a current deduction for mining exploration and development costs, he was required to include 90% of such costs in the AMT base. If this taxpayer never again became subject to AMT, not only 90% of mining exploration and development costs went unamortized for AMT purposes, the taxpayer also suffered the loss of regular tax benefit in the year of deduction due to the fact that the imposition of the AMT was permanent. The same was true of depreciation deductions (and other deferral preferences). Thus, a noncorporate taxpayer was required, for each year of the life of a depreciable asset, to include depreciation over and above the baseline deduction as a preference item and pay minimum tax on it. When the depreciation deductions for regular tax purposes fell below the baseline deductions, however, no negative adjustments were made to the AMT base and, consequently, the asset was never fully amortized for AMT purposes. The revised AMT eliminates these inequities by coordinating the regular and minimum tax systems. It employs two mechanisms to achieve this end: (i) an adjustment mechanism, and (ii) the alternative minimum tax credit.

The adjustment mechanism provided in §§56 and 58 requires the taxpayer to substitute minimum tax treatment for regular tax treatment of certain items. This will permit taxpayers to make negative adjustments. Consequently, in the case of depreciation deductions, for example, a taxpayer will be able to take a greater depreciation deduction for AMT purposes in later years than for regular tax purposes.

Also, the revised AMT permits a taxpayer a credit against regular tax in subsequent years for net AMT attributable to deferral items. Consequently, a taxpayer who takes a current deduction for mining exploration and development costs against the regular tax and pays AMT will be able to carry AMT over to subsequent years and credit it against regular tax.

In summary, the adjustment mechanism and the AMT credit are designed to ensure that a taxpayer is not disadvantaged by being on the AMT system in one year and on the regular tax system in another.

B. Computation of Net AMT Liability

As stated earlier, §55 imposes on noncorporate taxpayers an alternative minimum tax equal to the excess of the tentative minimum tax over the regular tax. Thus, although the alternative minimum tax is, in effect a true alternative tax in that it is imposed only if it exceeds the regular tax for the taxable year, technically, the regular tax continues to

[24] The tax incentives which will give rise to AMT liability are those which are enumerated in §§56, 57 and 58.

[25] Note that due to a small differential between the top marginal rate of regular tax for individuals (*i.e.* 28%) and the AMT rate (*i.e.* 21%) only a minimal use of tax incentives may trigger the AMT.

[26] Not all preferences and adjustments impose this burden on taxpayers. Some items, which enter into the AMT base, are fully disposed of in the year they arise, *e.g.*, tax-exempt interest, gain on installment sales, etc.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

be imposed and the amount of net minimum tax is the excess of the tentative alternative minimum tax over the regular tax for the taxable year.

The tentative minimum tax is obtained by multiplying the AMT base by 21% and substracting the AMT foreign tax credit therefrom. The tentative minimum tax is then compared to the taxpayer's regular tax (net of the regular tax foreign tax credit) to arrive at the net AMT liability.

The AMT base is computed by subtracting the exemption amount from alternative minimum taxable income. Alternative minimum taxable income is obtained by making certain adjustments to regular taxable income and adding back the sum of the items of tax preference.

These various steps involved in the computation of net AMT liability are fully analyzed in the sections that follow.

1. Alternative Minimum Taxable Income (AMTI)

As noted above, the first step in determining the AMT base is the computation of "Alternative Minimum Taxable Income." "Alternative Minimum Taxable Income" means the taxpayer's taxable income for the taxable year determined with the adjustments provided in §§56 and 58 and increased by the amount of the items of tax preference described in §57.[27] Thus, AMTI is determined in the same way as taxable income for regular tax purposes but with two types of modifications:

(i) adjustments are made to certain accounting practices and items of income and deductions to eliminate the tax preference or tax incentive element inherent in the treatment accorded to such accounting practices and items of income and deductions for regular tax purposes.

(ii) certain preference items, *i.e.*, certain exclusions from, and deductions taken against, gross income for regular tax purposes, are restored to AMTI.

The concept of adjustments introduced by the TRA 1986 is new to AMT. Some tax incentives which were labeled "items of tax preference" under prior law are, after the TRA, called adjustments, *i.e.*, depreciation deductions, amortization deductions for pollution control facilities, mining exploration and development costs, circulation expenditures, and research and development expenditures. In addition, certain items of adjustment have been introduced by the TRA 1986 which played no role in computing AMT under prior law, *i.e.*, disallowance of installment method of reporting, disallowance of completed contract method of accounting, disallowance of certain farm losses and passive losses, and exclusion of certain state and local tax refunds. Also, a modified version of itemized deductions allowed under prior law in determining the AMTI and the substitution of the alternative tax net operating loss deduction for the regular tax net operating loss deduction are, after the TRA, called adjustments.

The label of "tax preference," however, was not discarded. Section 57, which traditionally has dealt with the items of tax preference still retains some of the items (*i.e.* those that have not been repealed or redesignated as adjustments) that constituted tax preferences under prior law. That section also contains two items of tax preference added by the TRA 1986: tax-exempt interest and charitable contributions of appreciated property. The items of tax preference that have been repealed by the TRA 1986 include: dividends excluded under former §116 and the capital gains deduction under former §1202.

Note: The terms "adjustments" and "tax-preferences" are not mere labels. As explained below, the bifurcation of tax incentives (other than incentive credits) into "tax preferences" and "adjustments" by the 1986 Act has a profound significance. Prior to the 1986 Act, tax incentives (other than incentive credits), which involved merely a deferral of tax [28] were lumped together with tax incentives (other than incentive credits) which involved a permanent reduction or avoidance of tax [29] as tax preference items. The problem was not that both types of incentives were referred to as items of tax preference. Rather, the problem stemmed from the fact that both types of incentives received similar treatment in the computation of AMTI. This gave rise to inequitable results because, in the case of deferral incentives, when a taxpayer took up-front or accelerated deductions, he was exposed to AMT. In later years when the expenditure gave rise to income the taxpayer was subjected to regular tax on this income without any compensating adjustment for the AMT imposed earlier. Thus, the AMT in such cases assumed a penal character because although, in using a deferral incentive, the taxpayer was merely deferring regular tax, the AMT imposed, nonetheless, represented a final tax obligation.

Example: Suppose a taxpayer incurred $600X in circulation expenditures in 1984 and elected to take a current deduction under §173(a). The expenditures produced additional income of $500X in both 1985 and 1986. Suppose further that, the taxpayer was in the 50% tax bracket for all these years but that, in 1984, due to the circulation expenditures preference and some other preferences, the taxpayer was in an AMT position. In 1984, therefore, the taxpayer paid $80X in

[27] §55(b)(2).

[28] For example, a current deduction under §173(a) for circulation expenditures is a deferral incentive because it enables the taxpayer to defer the tax attributable to income offset by the current deduction to future years when the income attributable to the expenditures is generated. Assume a taxpayer in the 50% tax bracket incurred a $300 circulation expenditure in 1984 and elected to amortize it over a three-year period under §58(i). Assume further that this expenditure generated an additional income of $200 in each of the three years (*i.e.*, 1984, 1985, 1986). Since $100 of this additional income in each of the three years is offset by the circulation expenditures deduction, the taxpayer's net tax obligation attributable to the additional income in each of the three years is: 50% × ($200-$100) = $50. In other words, the taxpayer will pay an additional $50 in tax in 1984, 1985 and 1986. If, however, the taxpayer elected to take the entire $300 as a current deduction under §173(a) in 1984, his tax liability would be reduced by $150 (50% x $300) in 1984. On the other hand, the taxpayer's tax liability attributable to the additional income would be increased by $50 each in 1985 and 1986 because the deduction was utilized in 1984. Thus, the net effect of taking a current deduction would be to defer $100 of tax liability from 1984 to 1985 and 1986.

[29] The examples of such tax incentives included dividends excluded under §116 and the capital gains deduction. A taxpayer did not pay any regular tax attributable to such items. These items were included in the AMT base in the year in which they arose, however, and the taxpayer paid the minimum tax provided, of course, he was in an AMT position. The AMT imposed on these items represented the taxpayer's final tax obligation.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

AMT on $400X in circulation expenditures preference. In each of the taxable years 1985 and 1986, the taxpayer paid regular tax of $250X on the additional $500X income attributable to the circulation expenditures incurred and deducted in 1984. Had the taxpayer elected to amortize the $600X circulation expenditures ratably over a 3-year period under §58(i), the $200X of deductions in both taxable years 1985 and 1986 would have reduced the regular tax by $100X in those years. Thus, the taxpayer, by taking an up-front deduction in 1984 not only paid $80X in AMT but also paid an additional $100X in regular tax in 1985 and 1986.

To mitigate this form of double taxation, the 1986 Act, in addition to enacting an alternative minimum tax credit discussed below, divided the tax incentives (other than incentive credits) into "tax preferences" and "adjustments" and provided different treatment for each in computing AMTI. Items of tax preference are positive adjustments to AMTI, but only in the year in which they arise. On the other hand, not only may adjustment items be negative (the deduction for AMT purposes may be larger than that for regular tax purposes), but also, they may have an impact on AMT beyond the year in which they first arise. This treatment of deferral incentives, in conjunction with the minimum tax credit, is intended to ensure that these items are not subjected to both the minimum and the regular tax.

Example: Suppose a taxpayer incurs $600k in circulation expenditures in 1987 and elects to take a current deduction under §173(a). Since the taxpayer is in an AMT position in 1987, he pays AMT of $84k (21% of $400k in circulation expenditures preference). Under the adjustment mechanism, however, the taxpayer is entitled to amortize fully $600k of circulation expenditures over a 3-year period (*i.e.* 1987, 1988, and 1989) for AMT purposes. Thus, in computing his AMTI in 1988 and 1989, the taxpayer is entitled to a deduction of $200k against AMTI. If the taxpayer is in an AMT position in both of these years, the deduction will reduce his AMT by a total of $84k (21% × $200k + [21% × $200k]). In other words, the taxpayer will recoup the full amount of $84k paid in AMT in 1987. If the taxpayer is not in an AMT position in 1988 and 1989, the $84k of AMT paid in 1987 will be available as a credit against regular tax in 1988 and, if not fully absorbed in 1988, may be carried over to subsequent years until exhausted. Although the minimum tax credit may not reduce the regular tax below the tentative AMT, the $200k deduction (pertaining to the amortization of circulation expenditures) available against AMTI in each of the taxable years 1988 and 1989 will ensure that the $84k credit will be fully absorbed by regular tax in 1988 and 1989. Thus, it is clear that the AMT rules, as revised by the 1986 Act, are designed to ensure that a taxpayer is not subjected to both the AMT and the regular tax with respect to deferral incentives.

Finally, the adjustment items enumerated in §§56 and 58 do not involve deferral incentives. One adjustment, *i.e.*, the alternative tax net operating loss deduction, is merely an adjustment to regular taxable income. Another, itemized deductions, is more in the nature of a tax preference than a tax adjustment. By the same token, all items of tax preference enumerated in §57 do not involve permanent reduction or avoidance of tax. Two preferences, *i.e.*, intangible drilling and development costs and incentive stock options, share the deferral characteristic of adjustment items. The minimum tax credit, however, recognizes this and includes these preferences in items with respect to which the credit is available.

a. Items of Adjustment

The first step in the determination of AMTI is to recompute taxable income by providing a different and prescribed treatment to certain items in lieu of the treatment given such items for regular tax purposes. The taxpayer starts the computation of AMTI as if he were computing taxable income for regular tax purposes but with one difference: he disregards the regular tax treatment of items of adjustment and substitutes the treatment prescribed in §§56 and 58 for these items. This section deals with the items of adjustment and how they must be adjusted in arriving at AMTI.

(1) Accelerated Depreciation Deductions

(a) General

The 1986 Act completely revised the Accelerated Cost Recovery System (ACRS) of §168.[30] The statutory accelerated percentages for personal property, the Service's authority under which accelerated percentages were prescribed for real property as well as the optional straight-line percentages prescribed for all ACRS property were eliminated. Under the revised ACRS, the taxpayers must compute their recovery deductions by applying a statutory formula.

(i) Revised ACRS

Revised §168 provides that, generally for tangible property placed in service after December 31, 1986, a taxpayer's depreciation deduction must be determined by using (i) the applicable depreciation method, (ii) the applicable recovery period, and (iii) the applicable convention. The applicable depreciation methods are set forth in §168(b), the applicable classification and recovery period rules are contained in §§168(e) and 168(c), respectively, and the rules pertaining to applicable convention are provided in §168(d).

The post-TRA ACRS relies on the Asset Depreciation Range (ADR) guidelines for classifying assets. Generally, the ADR class lives are provided in Rev. Proc. 83-55, 1983-1 C.B. 745. Also, the Conference Report provides new ADR lives for some assets by either reclassifying assets or providing lives for assets not previously included in the ADR scheme. In summary, under the ACRS, as revised by the 1986 Act, personal property is grouped into six classes having recovery periods that extend from 3 to 20 years (with no salvage value):

(i) The 3-year class includes property with an ADR class life of four years or less and certain race horses.

[30] *See* Chapter 4, *supra,* for a discussion of amendments made to the ACRS system by the 1986 Act.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Automobiles and trucks are excluded from this class even though they have a 4-year ADR life.

(ii) The 5-year class includes property with an ADR class life of more than four years, but less than ten years. In addition, automobiles, light trucks, qualified technological equipment, computer-based central office switching equipment, certain renewable energy and biomass property, and research property are classified as 5-year property.

(iii) The 7-year class includes property with an ADR class life of at least 10 years and less than 16 years. This class also includes single-purpose agricultural and horticultural structures, railroad tracks, and property which does not have an ADR life and is not classified elsewhere.

(iv) The 10-year class includes property with an ADR life of at least 16 years and less than 20 years. Note that manufactured homes are not included in this class.

(v) The 15-year class consists of property with ADR life of at least 20 years, but less than 25 years. It also includes sewage treatment plants, telephone distribution plants and comparable equipment for two-way voice and data communication.

(vi) The 20-year class includes property with an ADR life of at least 25 years. It also includes municipal sewer pipes but excludes real property with an ADR midpoint of 27.5 years or more.

Real property is generally classified as either nonresidential real property or residential rental property. Nonresidential real property, which includes all real property that is not residential rental property and which does not have an ADR class life of less than 27.5 years, is assigned a recovery period of 31.5 years. Residential rental property, which includes manufactured homes and any building or structure generating at least 80% of its gross rental income from the rental of dwelling units, is assigned a recovery period of 27.5 years. Any other real property with an ADR class life of less than 27.5 years is generally assigned to the 20-year class.

Section 168(b) provides that property in 3, 5, 7, or 10-year class may be depreciated using a 200% declining balance method, switching to the straight-line method when the latter yields a larger deduction. Property in the 15 or 20-year class, however, must be depreciated by using a 150% declining balance method, switching to the straight-line method when the latter yields a greater deduction. The taxpayer may elect to use a straight-line method for property in any class.

Nonresidential real property and residential rental property must be depreciated using the straight-line method.

The applicable convention under revised §168(d) for all property other than real property is generally the half-year convention. A mid-quarter convention, however, must be used if the total bases of property which is subject to revised §168 and placed in service during the last three months of the taxable year exceed 40% of the total bases of all such property placed in service during that entire taxable year. For real property, the applicable convention is the mid-month convention. Also, under the revised ACRS, the half-year convention has been modified to provide a half-year's depreciation allowance for the year in which property is disposed of in cases where the disposition occurs during the recovery period.

Finally, as under the pre-TRA 1986 law, salvage value is disregarded in determining the depreciation deductions.

(ii) Alternative Depreciation System

Revised §168(g) provides for an "alternative depreciation system" for various types of property which, under the pre-TRA 1986 ACRS, was depreciated under special rules. The types of property subject to the alternative depreciation system include:

(i) Foreign Use Property. This includes property that is used outside the United States for more than half of a taxable year. Satellites and other property used in space are not treated as foreign use property if launched from the United States by a U.S. person.

(ii) Tax-Exempt Use Property. This includes property leased to, or otherwise used by, a tax-exempt entity.

(iii) Tax-Exempt Bond Financed Property. This includes property financed with the proceeds of tax-exempt bonds. If a part of the property is financed through conventional sources, the costs for that portion may be recovered under the regular depreciation system.

(iv) Imported Property. If a foreign country restricts U.S. imports or otherwise engages in discriminatory trade practices, the President of the United States may, by Executive Order, mandate the application of the alternative depreciation system to property imported from such foreign country. "Imported property" is defined as property that is manufactured outside the United States or property that has less than half its value added within the United States.

The recovery period for property subject to the alternative depreciation system is generally the ADR class life. Real property is assigned a recovery period of 40 years. Personal property with no assigned class life under the ADR guidelines is assigned a 12-year recovery period. In addition, a few other assets have been assigned special recovery periods for alternative depreciation system: five years for automobiles, light trucks and qualified technological equipment; 10 years for railroad tracks; 15 years for single-purpose agricultural structures; and 24 years for municipal wastewater treatment plants and telephone distribution plant and equipment.

The applicable depreciation method is the straight-line method for all classes of property. The half-year convention applies to personal property and the mid-month convention applies to real property.

The alternative depreciation system, as described above, also applies in computing a corporate taxpayer's earnings and profits for a taxable year under revised §312(k)(3), and in determining AMTI.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Finally, §168(g)(7) provides that, in lieu of using the accelerated or straight-line methods of depreciation over a property's regular recovery period, a taxpayer may elect to use the alternative depreciation system for any class of personal property placed in service during the taxable year. The election is made on a class-by-class and year-by-year basis. Thus, a taxpayer may choose to depreciate 3-year property under the regular depreciation system (ACRS) and 5-year property under the alternative system. The following year the taxpayer may choose to depreciate the 3-year property under the alternative depreciation system and 5-year property under the regular depreciation system (ACRS). Once an election to apply the alternative depreciation system to an item of property in a particular class is made it applies to all items of property in that class, however. An election to apply the alternative depreciation system to nonresidential real property and residential rental property, however, may be made on a property-by-property basis. An election under §168(g)(7), once made, may not be revoked.

(b) Definition

Technically, for all real and personal property placed in service after December 31, 1986,[31] the amount of adjustment equals the excess of the depreciation deduction under ACRS for the taxable year over the deduction that would be allowable under the alternative depreciation system with one modification: the 150% declining balance method (in lieu of the straight-line method) may be used for property other than §1250 property.[32] In practical terms, however, in computing AMTI, the ACRS deduction for all property placed in service after December 31, 1986, is replaced by a deduction computed under the alternative depreciation system with appropriate modifications.

As noted above, the alternative depreciation system provides recovery periods which are longer than the recovery periods under ACRS. For example, for purposes of the alternative depreciation system, 3-year recovery property may have an ADR class life of as long as four years; 5-year recovery property may have an ADR class life of as long as nine years; 7-year recovery property may have an ADR class life of as long as 15 years; and so on. Also, since, under ACRS, a 200% declining balance method is used for all property other than §1250 property as opposed to 150 percent declining balance method for AMT purposes, the depreciation deduction in the earlier years invariably is greater for regular tax purposes than for AMT purposes.

(i) Real Property

The alternative depreciation system assigns a recovery period of 40 years to both nonresidential real property and residential rental property, as compared to 27.5 years for residential rental property and 31.5 years for nonresidential real property under ACRS. Real property, however, is required to be depreciated under the straight-line method under both ACRS and the alternative depreciation system. Thus, in computing AMTI, the depreciation deduction for all §1250 property is determined by using a 40-year recovery period under the straight-line method. It is obvious, therefore, that all real property will result in an upward adjustment to AMTI unless the taxpayer elects to use the 40-year recovery period for regular tax purposes.

(ii) Personal Property

The depreciation deduction, for purposes of computing AMTI, is determined by using the asset's ADR class life and a half-year convention under the 150% declining balance method.[33] The taxpayer may switch to the straight-line method in later years when it would yield a larger deduction than under the 150% declining balance method. The taxpayer, however, is not permitted to use the 150% declining balance method for any property if, for regular tax purposes, the depreciation deduction for such property under §168 was computed using the straight-line method.[34] Since, for regular tax purposes, §168 provides shorter recovery periods and a 200% declining balance method of depreciation, it is obvious that, in earlier years, the taxpayer's deduction against regular taxable income will be greater than his deduction against AMTI resulting in AMT liability. For example, if a taxpayer puts an asset in the 3-year class with an ADR class life of four years in service in 1987, then assuming a cost basis of $3000, depreciation deductions for regular tax and AMT in 1987 are computed as follows:

$$\text{Regular Tax} = \tfrac{1}{2}(200\% \times \$3{,}000) \div 3 = \$1{,}000$$

$$\text{AMT} = \tfrac{1}{2}(150\% \times \$3{,}000) \div 4 = \$563$$

Assuming, in the above example, the taxpayer elected to use the straight-line method in lieu of the double declining balance method for purposes of determining his depreciation deduction for regular tax purposes, his deduction for regular tax and AMT are as follows:[35]

$$\text{Regular Tax} = \tfrac{1}{2}(100\% \times \$3{,}000) \div 3 = \$500$$

$$\text{AMT} = \tfrac{1}{2}(100\% \times \$3{,}000) \div 4 = \$375$$

Note that the depreciation adjustment applies to all personal property whereas, under prior law, the depreciation preference applied only to leased personal property. Also, under prior law, the depreciation preference was computed on an item-by-item basis, thus precluding netting. Under the revised AMT, however, the mechanics of computing AMTI clearly permit netting.

The following example illustrates how the post-TRA adjustment mechanism operates and how it differs from the pre-TRA preference mechanism.

Example: Taxpayer X, an individual sole proprietor, places assets A and B in service in 1987. Asset A has a cost basis of $3,000; it belongs to the 3-year class and

[31] The depreciation deduction adjustment may also apply to property placed in service before December 31, 1986, in one limited instance: when the taxpayer makes an election under §203(a)(1)(B) of the TRA 1986 to have the amendments made by the Act to ACRS apply to property placed in service after July 31, 1986 but before January 1, 1987.

[32] §56(a)(1).

[33] §56(a)(1)(A)(ii).

[34] *Id.*

[35] The taxpayer must use the straight-line method since he used the straight-line method for regular tax purposes.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

has an ADR life of 4 years. Asset B has a cost basis of $5,000; it belongs to the 5-year class and has an ADR life of seven years. The following table shows the depreciation deductions for both assets for regular tax and AMT purposes over the depreciable lives of the two assets.

Year		*Asset A (Cost Basis $3,000)*	*Asset B (Cost Basis $5,000)*	*Total Depreciation Deduction*
1987	Regular Tax	1,000	1,000	2,000
	AMT	563	536	1,099
1988	Regular Tax	1,334	1,600	2,934
	AMT	914	957	1,871
1989	Regular Tax	444	960	1,404
	AMT	609*	752	1,361
1990	Regular Tax	222	576	798
	AMT	609	612*	1,221
1991	Regular Tax	—	576*	576
	AMT	305	612	917
1992	Regular Tax	—	288	288
	AMT	—	612	612
1993	Regular Tax	—	—	—
	AMT	—	612	612
1994	Regular Tax	—	—	—
	AMT	—	307	307

Assumption 1: Asset A is in the 3-year class and has an ADR life of four years.

Assumption 2: Asset B is in the 5-year class and has an ADR life of seven years.

Assumption 3: The half-year convention is used throughout.

*In this year, the switch is made to the straight-line method to maximize the taxpayer's deduction.

Observation 1: Note in the Total Depreciation Deduction column that X is allowed a depreciation deduction of $2,000 in computing his regular taxable income for 1987. In determining his AMTI for 1987, however, X is required to substitute $1,099 for $2,000 as his depreciation deduction, an upward adjustment of $901. Assuming no other adjustments and preferences, X's AMTI for 1987 will be greater than his regular taxable income by $901, thus exposing him to AMT.

Observation 2: With respect to Asset A, note that the depreciation deduction available to X in computing regular taxable income is greater than the deduction available in computing AMTI in 1987 and 1988. This situation, however, is reversed in 1989, 1990 and 1991 when the AMTI deduction is greater than the regular tax deduction. Under pre-1986 TRA law, X would have a depreciation preference of ($1,000 − $563) = $437 in 1987 and of ($1,334 − $914) = $420 in 1988. But, in 1989, 1990 and 1991 when the regular tax deduction falls below the minimum tax standard, X would get no negative adjustment, *i.e.*, AMTI would not be reduced by the amount by which the minimum tax deduction exceeded the regular tax deduction. The adjustment mechanism under the revised AMT changes this. In 1989, for example, X gets a depreciation deduction of $444 in computing his regular taxable income while he receives a deduction of $609 in determining his AMTI, a downward adjustment of (609 − 444) = $165 to AMTI. He also gets downward adjustments of ($609 − $222) = $387 in 1990 and ($305 − 0) = $305 in 1991. Thus, his total upward adjustments in computing AMTI of ($437 + $420) = $857 over the life of Asset A exactly equal his total downward adjustments in computing AMTI of ($165 + $387 + $305) $857 over the life of Asset A. This, in effect, means that the downward adjustments, which push the AMTI below the regular taxable income, will compensate X in later years either by offsetting other upward adjustments to AMTI or through the minimum tax credit mechanism for AMT imposed in 1987 and 1988.

Observation 3: Note the netting effect of the adjustment mechanism in 1989. For Asset A, X has a depreciation deduction of $444 for regular taxable income purposes and a deduction of $609 for AMTI purposes, a downward adjustment of ($609 − $444) = $165 to AMTI. For Asset B, however, X has a depreciation deduction of $960 for regular taxable income purposes and a deduction of $752 for AMTI purposes, an upward adjustment of ($960 − $752) = $208 to AMTI. On a combined basis, however, X only has an upward adjustment of ($1,404 − $1,361) = $43 to AMTI in 1989 because the upward and downward adjustments are netted.

Observation 4: Note the necessity of keeping two different depreciation schedules for personal property placed in service after 1986: one for regular tax purposes and another for AMT purposes. If Asset A was the only asset placed in service by X in 1987 and 1991 was the first year he became subject to AMT, he would be required to go back to 1987 and reconstruct his depreciation schedule for Asset A for purposes of his AMTI computations in 1991.

(c) Exceptions

Not all depreciable personal property placed in service after 1986 gives rise to adjustments to AMTI under §56(a)(1). Under §§56(a)(1)(B) and 56(a)(1)(C), the adjustment does not apply to the following types of property.

(i) sound recordings described in §48(r)(5).[36]

(ii) films and video tapes which are generally depreciated under the income forecast method.[37]

(iii) any property which is depreciated under the unit-of-production method or any other method of depreciation not expressed in terms of years.[38]

(iv) any property with respect to which the taxpayer makes an election to depreciate under the alternative depreciation system.[39]

[36] §§56(a)(1)(B) and 168(f)(4).
[37] §§56(a)(1)(B) and 168(f)(3).
[38] §§56(a)(1)(B) and 168(f)(1)(B).
[39] §§56(a)(1)(B) and 168(f)(1)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(v) certain public utility property (within the meaning of §167(l)(3)(A)) if the taxpayer does not use a normalization method of accounting.[40]

(vi) certain property placed in service after December 31, 1986, which qualifies for transitional relief and therefore is excepted from the application of the revised ACRS rules.[41]

(vii) property which is expensed under §179.[42]

In all the cases enumerated above, the depreciation deduction allowed for computing regular taxable income will be the deduction allowable in computing AMTI. Consequently, these types of property will have no impact on a taxpayer's AMT liability.

(d) AMT Planning

A taxpayer who finds himself in an AMT position in the current taxable year and who has placed certain depreciable assets in service during the year has some planning options. For instance, take the case of X in the Example above. If X finds that he is pushed into an AMT position in 1987 by taking rapid write-offs (under the 200% declining balance method) on Assets A and B, he should consider electing under §168(b)(5) to apply a straight-line method to either or both A and B. In the Example, if X elects to depreciate both assets A and B under a straight-line method, his depreciation deduction in computing regular taxable income for 1987 would be $1,000, whereas his deduction in computing AMTI would be $1099. This would not only eliminate any AMT exposure arising from depreciation of Assets A and B, but also would provide X with a $99 cushion to absorb upward adjustments in AMTI resulting from other sources.

Where taxpayers are in an AMT position without regard to the depreciation deductions attributable to assets placed in service during the current taxable year, a §168(g)(7) election provides them with a powerful tool to manage their AMT liability. Again take the case of X in the Example above. Suppose he has other preferences and adjustments in 1987 which subject him to AMT. X may elect under §168(g)(7) to depreciate both A and B under the alternative depreciation system. Thus, in 1987 X's depreciation deduction for regular tax purposes will be ½(100% of 3,000 ÷ 4) = $375 for Asset A and ½(100% of 5,000 ÷ 7) = $357 for Asset B. Since the deduction for AMTI purposes is $1,099 for both A and B, X's AMTI for 1987 will be adjusted downward by (1099 − 375 − 357) = $367. In other words, X will be able to absorb $367 by electing to depreciate A and B under the alternative depreciation system.

Comment: Electing under §168(g)(7) to depreciate property under the alternative depreciation system will always provide the taxpayer with a cushion to absorb upward adjustments in AMTI resulting from other sources. This is so because, while the recovery periods are the same for both regular tax and AMT purposes, the depreciation deduction for regular tax purposes must be computed using the straight-line method, whereas the 150% declining balance method is used in computing the depreciation deduction for AMT purposes. Therefore, a judicious use of the elections under §§168(b)(5) and 168(g)(7) can be an invaluable tool in managing a taxpayer's AMT liability, especially since these elections may be made on a class-by-class and year-by-year basis.

(2) Amortization of Pollution Control Facilities

(a) General

Section 169 provides that, with respect to any certified pollution control facility, a taxpayer may elect to amortize the amortizable basis of such property over a 60-month period. Since the ADR class lives or the recovery periods under the ACRS of such facilities would be much greater than 60 months, the rapid write-offs provided by §169 have traditionally been treated as a tax preference item.

(b) Definition

In computing AMTI, any rapid amortization deduction under §169 taken with respect to a certified pollution control facility placed in service after December 31, 1986, is disregarded and a deduction computed under the alternative depreciation system of §168(g) is substituted.[43] As discussed earlier, the depreciation deduction for each pollution control facility will be computed by using the ADR class life of such facility under the straight-line method. Thus, the upward adjustment in AMTI would equal the excess of the 60-month amortization deduction over the deduction computed under §168(g).

The discussion pertaining to the accelerated depreciation deductions adjustment in the preceding section generally applies to certified pollution control facilities amortization adjustment also.

(3) Mining Exploration and Development Costs

(a) General

Under §§616 and 617, a taxpayer is permitted to treat expenditures incurred for development and exploration of a mine as expenses deductible in the year paid or incurred. But for §§616 and 617, these expenditures would receive the less favorable tax treatment of capitalization and amortization over the producing life of the mine which would result in much smaller deductions spaced over many years.

(i) Mining Exploration Costs

Section 617(a) provides that a taxpayer may elect to deduct currently expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas), provided such expenditures are incurred prior to the beginning of the development stage. The election under §617(a) does not apply to amounts which would not otherwise be allowable as a deduction for the taxable year. Accordingly, to the extent exploration expenditures are allocable to worthless property, they may be deductible under §165 but are not subject to the §617(a) election. The §617(a) election also does not apply to the following amounts:

[40] §§56(a)(1)(B) and 168(f)(2).
[41] §56(a)(1)(C).
[42] Sen. Rep. No. 313, 99th Cong., 2d Sess., p. 522, footnote 5 (1986). ("Senate Report").
[43] §56(a)(5).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(i) Amounts for which a percentage depletion deduction would not be available under §613.[44]

(ii) Amounts incurred in the acquisition or improvement of depreciable property; however, a depreciation allowance may be claimed with respect to such amounts.[45]

(iii) Amounts incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas) located outside the United States.[46]

Regs. §1.617-1(a) provides that the development stage of a mine or other natural deposit will be deemed to begin when, in consideration of all the facts and circumstances, deposits of ore or other mineral are disclosed in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. For example, core drilling expenditures paid or incurred by the taxpayer to ascertain the existence of commercially marketable ore are exploration expenditures. Also, expenditures for exploratory drilling from within a producing mine to ascertain the existence of what appears to be a different ore deposit qualify as exploration expenditures.

An election under §617(a) may be made by a taxpayer by deducting exploration expenditures on his income tax return for his first taxable year ending after September 12, 1966, for which he desires to deduct such expenditures.[47] For any taxable year for which a §617(a) election is effective, however, the taxpayer must deduct all expenditures currently to which §617(a) applies.[48] A §617(a) election, once made, cannot be revoked without the prior consent of the Commissioner.[49]

When a mining property with respect to which deductions have been taken for mining exploration costs under §617(a) is disposed of, such costs are subject to recapture as ordinary income under either §1254 or §617(d). In case both §1254 and §617(d) apply, §1254 will take precedence. When a mining property with respect to which mining exploration costs have been deducted under §617(a) reaches the production stage, such costs are subject to recapture under §617(b).

When a mine reaches the producing stage, §617(b)(1) provides two methods of recapture. Under the first method, the taxpayer must forego depletion on all mines or deposits reaching the producing stage during the taxable year until the amount of depletion which would have been allowed on each mine or deposit equals the amount of adjusted exploration expenditures with respect to such mine or deposit. Under the second method, the taxpayer may elect to include in gross income for the year an amount equal to the adjusted exploration expenditures with respect to all mines reaching the producing stage during that year. The amount included in gross income becomes part of the depletable bases of the respective mines; however, it is not considered to be gross income from the property for percentage depletion purposes. Adjusted exploration expenditures are defined as the exploration expenditures paid or incurred with respect to any property under §617(a) in all years reduced by: (i) the amount (if any) by which the deduction for percentage depletion, which would have been allowable for all years if no deduction for the exploration expenditures under §617(a) had been allowed, exceeds the actual depletion allowed for the corresponding years; (ii) the aggregate of all amounts included in gross income under §617(b) and §617(c); and (iii) the amount of gain to which §617(d) applies.

If a taxpayer does not make an election under §617(a) to currently deduct the mining exploration expenditures, such expenditures are capitalized and become part of the depletable basis of the property.

(ii) Mining Development Costs

Section 616(a) provides that a taxpayer may deduct all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well), provided the expenditures are paid after the existence of ores or minerals in commercially marketable quantities has been discovered. Section 616(a) does not, however, cover the cost of acquiring depreciable property. Regs. §1.616-1(a) provides that the development stage of a mine is reached when, taking into account all facts and circumstances, deposits of the minerals are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. The Service, in Rev. Rul. 69-540, 1969-2 C.B. 143, set down general guidelines for determining whether expenses are development expenditures. According to the ruling, development expenditures are those resulting directly from the mining process or activity of making the mineral in place accessible for production operations through the removal of material, by the driving shafts, tunnels, galleries and similar processes or activities. For §616(a) to apply, the mine must be in the development stage, expenditures must be for preparing the mineral deposit for extraction, and the expenditures must not be for equipment or facilities which related solely to the extraction of the mineral from the mine.

Section 616(b) provides that a taxpayer, instead of deducting development costs currently, may elect to defer such costs. If an election under this section is made with respect to a mine, then the excess of such costs incurred during the taxable year over net receipts is deductible ratably as the mineral benefits are produced and sold. This method of amortization is similar to cost depletion. Note, however, that the deferred development costs are not capitalized as mineral property cost for depletion purposes; the amortization on such costs is allowable as an ordinary deduction in addition to the depletion deduction in the years benefited. The election under §616(b) may be made on a mine-to-mine basis.[50] It applies only to expenditures incurred during the taxable year for which it is made.[51] However, it must cover all development expenditures for the taxable year for each mine. The election, once made, is irrevocable.[52]

[44] §617(a).
[45] *Id.*
[46] §617(h).
[47] Regs. §1.617-1(c)(1)(i).
[48] Regs. §1.617(c)(1)(iii).
[49] Regs. §1.617-1(c)(1)(ii).
[50] Regs. §1.616-2(e)(2).
[51] Regs. §1.616-2(e)(1).
[52] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(b) Definition

Mining development and exploration costs paid or incurred after December 31, 1986, which are allowable as a current deduction in computing regular taxable income under §616(a) or 617(a) must, for purposes of computing AMTI, be capitalized and amortized ratably over a 10-year period beginning with the taxable year in which the expenditures are made.[53] Thus, if a taxpayer takes a current deduction under §616(a) or §617(a) for mining development and exploration expenditures, his AMTI for the taxable year will be adjusted upward by 90% of such expenditures.

Example: A incurs $1,000 in mining exploration costs in 1987 and elects under §617(a) to deduct these costs currently in computing his regular taxable income. For purposes of computing his AMTI, A will be entitled to deduct only ($1,000 x 10%) = $100 in 1987. Assuming no other adjustments or preferences, A's AMTI for 1987 will be greater than his regular taxable income by $900.

If a taxpayer suffers a loss with respect to a mining property (*e.g.*, it is abandoned as worthless) for which deductions have been taken under §616(a) or 617(a) for mining development or exploration costs then, for purposes of computing AMTI, the entire unamortized portion of such costs is deductible in the year of the loss.[54] The amount of this loss deduction in computing AMTI is subject to only one limitation: it may not exceed the amount that would be allowable as a loss deduction under §165(a) had such costs remained capitalized.[55]

As stated earlier, mining exploration expenditures deducted under §617(a) are recaptured as ordinary income when the mine, with respect to which such expenditures were incurred, reaches the production stage or is disposed of. If the mining property is not disposed of, the recapture takes the form of either a denial of depletion deduction or inclusion in gross income. Either way, the downside of taking a current deduction for exploration costs under §617(a) is that, in later years, gross income is increased by the amount of the deduction. Mining development expenditures involve a similar mismatching of income and deductions because income is generally produced in year(s) subsequent to the year in which development expenditures are incurred and deducted. Section 56(a)(2) neutralizes this tax deferral effect of current deductions under §§616(a) and 617(a) by requiring a 10-year amortization of mining exploration and development expenditures. By the same token, a taxpayer who pays AMT due to the mining exploration and development costs adjustment, is compensated in later years for the amount of such AMT in either of the following two ways: (i) if the taxpayer is an AMT position, the 10% amortization deduction attributable to §616(a) and/or 617(a) costs deducted in an earlier year will adjust the AMTI downward in each of the following 10 years, thus reducing the AMT the taxpayer would otherwise owe; or (ii) if the taxpayer is not in an AMT position, the AMT credit stemming from the AMT imposed due to an adjustment made pursuant to §56(a)(2) will offset the regular tax in subsequent years until exhausted.

Finally, §59(e) provides a taxpayer with an option to eliminate the minimum tax impact of mining exploration and development costs. Under §59(e), a taxpayer may elect to amortize mining development and exploration costs ratably over a 10-year period for regular tax purposes. If this election is made, §56(a)(2) does not apply to such costs.

(c) AMT Planning

The upward adjustment to AMTI resulting from mining development and exploration costs deducted under §616(a) or 617(a) (or from any other §56 item for that matter) may not be undesirable in all cases. This is because a taxpayer may have downward adjustments to AMTI in the current year from other sources which may offset the upward adjustment. For example, the taxpayer may have deducted circulation expenditures under §173, or research and experimental expenditures under §174, or even mining development or exploration expenditures under §616(a) or 617(a) in an earlier year which give rise to downward adjustments to AMTI in the current year. On the other hand, a current deduction under §616(a) or §617(a) may be wholly undesirable for one reason or another, *e.g.*, because it kicks in the phase-out of the exemption amount under §55(d)(3). Consequently, when a taxpayer incurs mining development or exploration costs he must determine to what extent, if any, an upward adjustment to AMTI in the taxable year is undesirable, especially since he has important options at his disposal to manage the amount of such adjustment. These options are discussed below.

(i) Mining Exploration Costs

The taxpayer has the option not to elect under §617(a) to take a current deduction for mining exploration costs. If an election under §617(a) is not made, mining exploration costs are capitalized and become part of the depletable basis of the mining property. Alternatively, the taxpayer may elect under §59(e) to capitalize and amortize mining exploration costs ratably over a 10-year period beginning with the year in which such costs are paid or incurred. Some of the relevant considerations bearing upon these options are summarized below.

(i) If the exploration costs are capitalized, they increase the taxpayer's depletable basis and, hence, the cost depletion deduction for regular tax purposes without any AMT exposure. Capitalization and the resulting increase in basis, however, will yield no benefit in terms of the size of the depletion deduction for regular tax purposes if the taxpayer claims percentage depletion. Provided the taxpayer claims percentage depletion, an election under §59(e) will yield an additional amortization deduction for regular tax purposes.

(ii) Since an election under §617(a) applies to all mining exploration costs paid or incurred during the taxable year,[56] the taxpayer may not capitalize a portion of such costs under §263. An election under §59(e), on the other hand, permits the taxpayer to

[53] §56(a)(2)(A).
[54] §56(a)(2)(B).
[55] *Id.*
[56] §617(a)(2)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

capitalize and amortize ratably over a 10-year period any portion of mining exploration costs.[57]

(iii) An election to currently deduct mining exploration costs under §617(a) applies to such costs paid or incurred not only in current taxable year but also in any subsequent taxable year.[58] Consequently, if mining costs paid or incurred are deducted under §617(a) in the current taxable year, a portion of such costs paid or incurred in a subsequent taxable year may not be capitalized unless the Commissioner's consent is obtained to revoke the §617(a) election. On the other hand, since an election under §59(e) may be made with respect to a portion of mining exploration costs paid or incurred during a taxable year, it is obviously not binding on such costs incurred during a subsequent taxable year. Thus, if the taxpayer chooses to elect under §59(e), mining exploration costs incurred in a subsequent taxable year may be deducted under §617(a) or may be capitalized under §263.

(iv) If mining exploration expenditures are capitalized and amortized pursuant to a §59(e) election, the deducted expenditures shall, upon a subsequent disposition of the mining property, be recaptured as ordinary income under either §1254 or §617(d).[59] No such recapture, however, will be required if such costs are capitalized under §263 and recovered as depletion deductions.

Comment: Since, in taxable years beginning after 1987, capital gains and ordinary income are taxable at the same tax rates, the significance of recapture has been reduced considerably.

Comment: If a taxpayer chooses to capitalize only a portion of mining exploration costs under §59(e), must the taxpayer capitalize the balance of such costs under §263, or does he have the option to deduct the balance under §617(a)? If taxpayer may deduct the balance under §617(a) it will enable him to manage the amount of upward adjustment in AMTI in precise terms by controlling the amount of mining exploration costs that is subjected to the §59(e) election. Since §617(a)(2)(B) provides that an election under §617(a) applies to all mining exploration costs paid or incurred during the taxable year, there is a tension between §617(a) and §59(e). Since §59(e)(3) clearly provides that no other Code sections apply to amounts subject to an election under that section, however, it appears that §617(a)(2)(B) should not preclude capitalization of a portion of exploration costs under §59(e) while the balance is deducted under §617(a).

(ii) Mining Development Costs

Although mining development costs are capital in nature, §616(a) permits taxpayer to take a current deduction for such costs. In lieu of taking a current deduction, however, the taxpayer may elect under §616(b) to capitalize such costs with respect to each mine or deposit and amortize them ratably as the units of the produced ore or minerals benefitting from such costs are sold.[60] Note that, although the deferred mining development costs are not capitalized for depletion purposes, they are considered part of the adjusted basis for all other purposes.[61] The taxpayer also has the option to elect under §59(e) to capitalize and amortize any portion of mining development costs paid or incurred during the taxable year. Some of the considerations bearing upon a choice between an election under §616(b) election or a §59(e) election are summarized below.

(i) If an election under §616(b) is made, only that portion of the mining development costs may be deferred which is in excess of the net receipts from the ore or the minerals from the mine received or accrued during the same taxable year as the costs were paid or incurred.[62] The mining development costs not in excess of such receipts must be deducted currently under §616(a). An election under §59(e) permits taxpayer to capitalize all mining development costs regardless of the net receipts restriction.

(ii) An election under §616(b) may be made on a mine-by-mine basis. An election under §59(e), on the other hand, may be made with respect to any portion of mining development expenditures paid or incurred during the taxable year with respect to a particular mine.

(iii) The taxpayer may use both options and a current deduction under §616(a) concurrently: he may capitalize mining development costs with respect to one mine under §616(b), he may capitalize a portion of mining development costs with respect to other mines under §59(e), and deduct currently under §616(a) the balance of mining development costs with respect to other mines. A skillful manipulation of these choices can ensure that the taxpayer will derive maximum benefit from mining development costs paid or incurred during the current taxable year for regular tax purposes without suffering any AMT detriment.

(4) Certain Long-Term Contracts

(a) General

The Tax Reform Act of 1986 modified the accounting rules that apply to taxpayers providing goods or services under long-term contracts. Prior to the 1986 Act, a taxpayer with income and expenses from long-term contracts could use the cash or accrual methods of accounting generally available to all taxpayers. At the taxpayer's election, however, income and expenses attributable to long-term contracts could also be reported under either of two special methods of accounting: (i) the percentage of completion method, or (ii) the completed contract method.

A long-term contract is a building, installation, construction, or manufacturing contract that is not completed within the taxable year in which it is entered into. A manufacturing contract qualifies as a long-term contract, however, only if it involves the manufacture of either unique items of a type not normally carried in the finished goods inventory of the taxpayer, or items normally requiring more than 12 months to complete.[63]

[57] §59(e)(4)(A).
[58] *Id.*
[59] §59(e)(5).
[60] Regs. §1.616-2(a).
[61] §616(c).
[62] Regs. §1.616-2(a).
[63] Regs. §1.451-3.

Under the percentage of completion method, income is recognized according to the percentage of the contract that is completed during each taxable year. The determination of the portion of the contract completed during each taxable year may be made by either (i) comparing costs incurred during the year to the total estimated costs to be incurred under the contract, or (ii) comparing the work performed during the year with the estimated total work to be performed under the contract.[64] All costs attributable to a long-term contract are deductible in the year in which they are incurred.

Under the completed contract method of accounting, the entire gross contract price of a long-term contract is included in income in the taxable year in which the contract is completed and accepted. Also, all costs properly allocable to a long-term contract are deducted in the year of completion.

Under the amendments made by the TRA 1986, for long-term contracts entered into after February 28, 1986, taxpayers may elect to compute income from long-term contracts under one of two methods: (i) the percentage of completion method, or (ii) percentage of completion-capitalized cost method. Except in the case of certain real property construction contracts, these are the exclusive methods under which long-term contracts may be reported.

As under pre-TRA law, taxpayers may elect to use the percentage of completion method of accounting for long-term contracts. The 1986 Act, however, made several changes to the percentage of completion method of accounting:

(i) The exclusive method of determining the portion of the contract completed during the taxable year is the cost comparison method. The work-performed comparison method is no longer permissible.[65]

(ii) Contract costs are to be determined in accordance with the extended period long-term contract regulations provided in Regs. §1.451-3(b)(3).[66]

(iii) Interest must be allocated to the contract in accordance with the interest capitalization rules.[67]

(iv) Independent research and development costs; costs of unsuccessful bids and proposals; and marketing, selling and advertising costs are not allocable to long-term contracts.[68]

The percentage of completion-capitalized cost method is a hybrid method of accounting which combines the percentage of completion method and taxpayer's normal method of accounting. Under this method 40% of the long-term contract is reported under the percentage of completion method as described above.[69] The remaining 60% is reported under taxpayer's normal method of accounting.[70] Thus, 60% of the gross contract income will be recognized, and 60% of the contract costs will be deducted at the time required by taxpayer's normal accounting method. For example, if taxpayer uses the completed contract method, these items will be taken into account upon completion of the contract. If taxpayer uses an accrual method (*e.g.*, accrual shipment method), such contract items will be taken into account at the time of shipment.[71]

(b) Definition

For purposes of computing AMTI, any long-term contract entered into after February 28, 1986, must be accounted for under the percentage of completion method as modified by the 1986 Act. Thus, a taxpayer using percentage of completion-capitalized cost method for regular tax purposes will generally be required to make adjustments in AMTI. For instance, a taxpayer accounting for 40% of a long-term contract under the percentage of completion method and 60% under the completed contract method for regular tax purposes will be required to adjust AMTI upward in the early years. However, in the final year of the contract, when income for the 60% portion of the contract is recognized, there will be a downward adjustment in AMTI.

Any adjustments to AMTI may be eliminated by using the percentage of completion method for regular tax purposes.

(5) Installment Sales of Certain Property

(a) General

Prior to the Tax Reform Act of 1986, gain from certain sales of property in exchange for which the seller received deferred payments was reported on the installment method unless taxpayer elected otherwise. Eligible sales included dispositions of personal property on the installment plan by a person who regularly sold or otherwise disposed of personal property on the installment plan, and other dispositions of property including publicly traded property, where at least one payment was to be received after the close of the taxable year of the disposition.

The TRA 1986 modified the installment sales rules significantly. It enacted the proportionate disallowance rule which limits the use of the installment method based on a proportion of the taxpayer's outstanding debt. The rationale behind this rule is that, if a taxpayer holds installment obligations, part or all of his debt is related to those obligations. Either the extension of credit by the taxpayer necessitates borrowing or it enhances taxpayer's ability to borrow. Section 453C, therefore, limits the amount of gain that may be reported under the installment method from the following types of sales:

(i) sales made after February 28, 1986, of personal property by a person who regularly sells or otherwise disposes of the same type of personal property;

(ii) sales made after February 28, 1986, of real property held by the seller for sale to customers in the ordinary course of business; and

(iii) sales made after August 16, 1986, of real property used in the seller's trade or business or property held

[64] Regs. §1.451-3(c)(2).
[65] §460(b)(2)(A).
[66] §460(c)(1).
[67] §460(c)(3).
[68] §460(c)(4).
[69] §460(a)(1)(A).
[70] §460(a)(1)(B).

[71] For a discussion of the 1986 TRA rules governing long-term contracts, *see* Chapter 20, *supra*.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

for the production of rental income provided the sale price exceeds $150,000.

The proportionate disallowance rule operates by first determining the amount of a taxpayer's "allocable installment indebtedness" for each taxable year and treating such amount as a payment immediately before the close of the taxable year on "applicable installment obligations" that arose during that taxable year and that are outstanding at the end of the taxable year.[72] As a result, a portion of taxpayer's debt is treated as payment toward his installment obligation. The term "applicable installment obligation" is defined in §453(e) to mean an obligation arising from a sale of a type described in the preceding paragraph on an installment basis. The amount of "allocable installment indebtedness" is computed in accordance with the formula provided in §453C(b). The proportionate disallowance rule does not apply to the following transactions:

(i) disposition by an individual of personal use property;[73]

(ii) disposition of any property used or produced in the trade or business of farming;[74]

(iii) at the election of the taxpayer, sales of timeshares and unimproved lots of land provided the conditions of §453C(e)(4) are met; and

(iv) sales of tangible personal property by the manufacturer of the property to a dealer, but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed price after no longer than a 9-month period following the sale, and certain other conditions specified in §811(c)(2) of the Act are satisfied. The additional requirements of §811(c)(2) of the Act include: (i) for the taxable year in question and the preceding taxable year, the aggregate face amount of the obligations arising from qualified sales by the manufacturer is at least 50% of the total sales to dealers giving rise to such obligations; and (ii) the requirements of §811(c)(2) of the Act must be met by the taxpayer in his first taxable year beginning after October 22, 1986. For purposes of this provision, obligations issued before October 22, 1986, are treated as meeting the applicable requirements if such obligations are conformed to the requirements of §811(c)(2) of the Act by December 20, 1986.

Taxpayers who sell property on a "revolving credit plan" are not permitted to use the installment method. Such taxpayers are required to treat all payments as received in the year of disposition.[75] The term "revolving credit plan" is defined in Regs. §1.453-2(d).

Also, persons who sell stock or securities that are traded on an established securities market or, to the extent provided in Treasury regulations, property of a kind regularly traded on an established market are not permitted to use installment method.[76] All payments made to these persons will be treated as received in the year of disposition. Regulations are expected to provide that, where sales take place on an established market and settlement generally occurs several days after the trade date, both cash and accrual basis taxpayers will recognize gain or loss on the day the trade is executed and not on the day settlement occurs.[77]

The disallowance of the installment method for sales on revolving credit plans and for sales of publicly traded property is effective for sales of property made after December 31, 1986. The proportionate disallowance rule is effective as of January 1, 1987, for sales made on or after March 1, 1986. A taxpayer will treat installment obligations arising between March 1, 1986, but before the first taxable year ending after December 31, 1986, as having arisen during the first taxable year of the taxpayer beginning after December 31, 1986.

(b) Definition

For purposes of computing AMTI, gain from any disposition after March 1, 1986, of property to which proportionate disallowance rule of §453C applies, shall be determined without regard to the installment method and all payments shall be deemed to have been received in the year of disposition.[78] Thus, to the extent the proportionate disallowance rule permits the deferral of gain recognition upon the sale of personal and real dealer property and certain other business or rental realty, AMTI will be adjusted upward by an amount which equals the deferred gain. However, there will be no adjustments made to AMTI in cases of installment sales to which the proportionate disallowance rule does not apply, *i.e.*:[79]

(i) sales of personal use property by individuals,

(ii) disposition of any property used or produced in the trade or business of farming,

(iii) sales of timeshares and unimproved lots of land, and

(iv) certain sales of tangible personal property by manufacturers.

Comment: Although the revised AMT rules are not effective until 1987, §56(a)(6) disallows installment method of reporting income for sales made after March 1, 1986. The effect of this rule is that a taxpayer will recognize the entire gain from an applicable sale (*i.e.*, a sale that is subject to the proportionate disallowance rule) made after March 1, 1986, but within his taxable year beginning before January 1, 1987, for purposes of computing preTRA 1986 AMT. However, in later years when gain is recognized for regular tax purposes, no adjustment to AMTI will result.[80]

[72] §453C(a).
[73] §453C(e)(1)(B)(i).
[74] §453C(e)(1)(B)(ii).
[75] §453(j)(1).
[76] §453(j)(2).
[77] Senate Report at 132.
[78] §56(a)(6).
[79] §56(a)(6)(B) and §701(f)(3) of the Act.
[80] Senate Report at footnote 8, p. 526.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(6) Itemized Deductions

(a) General

The Tax Reform Act of 1986 made several changes to below-the-line [81] itemized deductions that are allowed in computing taxable income for regular tax purposes. The changes that are pertinent for AMT purposes are summarized below.

(i) Miscellaneous Deductions

Section 132(a) of the Tax Reform Act of 1986 added §67 to the Code imposing a 2% floor on miscellaneous deductions. The miscellaneous deductions are itemized deductions other than the following deductions:

(i) interest deduction under §163,

(ii) deduction for taxes under §164,

(iii) loss deductions under §165(c)(3) and §165(d),

(iv) charitable contributions deduction under §170.

(v) medical expense deduction under §213,

(vi) moving expense deduction under §217,[82]

(vii) any deduction allowed for impairment-related work expenses,

(viii) estate tax deduction under §691(c),

(ix) any deduction allowable in connection with personal property used in a short sale,

(x) deduction for amounts restored under claim of right under §1341,

(xi) deduction under §72(b)(3) (where annuity payments cease before investment is recovered),

(xii) deduction under §171 for amortizable bond premium, and

(xiii) deduction under §216 (relating to deductions in connection with cooperative housing corporations).

Thus, for taxable years beginning after December 31, 1986, all miscellaneous itemized deductions, other than those listed above, are allowable for regular tax purposes only to the extent they exceed 2% of the taxpayer's adjusted gross income. Some examples of these deductions include: unreimbursed employee expenses including union dues and professional fees, certain expenses related to investment income or property deductible under §212 (*e.g.*, attorney fees, financial planning fees), tax return preparation fees deductible under §212(3), etc.

(ii) Deduction for Taxes

Section 132(a)(1) amended §164 to disallow a deduction for state and local sales taxes. It also added §164(a)(5) to allow a deduction for generation skipping tax imposed by §2601 and any state tax described in §2604 with respect to property included in a generation skipping transfer. Consequently, for taxable years beginning after December 31, 1986, §164(a) allows a deduction for the following taxes:

(i) state, local, and foreign real property taxes,

(ii) state and local personal property taxes,

(iii) state, local and foreign income taxes,

(iv) windfall profit tax imposed under §4986, and

(v) generation skipping tax.

(iii) Medical Expense Deduction

Prior to the Tax Reform Act of 1986, an individual was allowed a deduction for medical expenses under §213 to the extent such expenses were in excess of 5% of his adjusted gross income for the taxable year. Act §133 increased this floor to 7.5% for taxable years beginning after December 31, 1986.

(iv) Interest Deduction

The Tax Reform Act of 1986 imposed new limitations on below-the-line deduction for investment and personal interest which are summarized below.

(I) Investment Interest

Section 163(d)(1) permits a taxpayer other than a corporation a deduction for investment interest, but only to the extent of the taxpayer's net investment income for the taxable year. Any investment interest disallowed may be carried forward to the following taxable year.[83]

"Investment interest" includes any interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.[84] Property held for investment includes property which produces portfolio income of the type described in §469(e)(1) (*i.e.*, interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business), and any interest in an activity involving the conduct of a trade or business with respect to which taxpayer does not materially participate and which is not a passive activity.[85] "Investment interest," however, does not include: (i) any qualified residence interest;[86] and (ii) any interest taken into account under §469 in computing income or loss from a passive activity.[87]

"Net investment income" means the excess of investment income over investment expenses.[88] Investment income is the sum of gross income produced by property held for investment and any net gain attributable to the disposition of such property.[89] Investment expenses include all deductible expenses (other than interest) which are directly connected with the production of investment income.[90]

Note that the investment interest limits are fully coordinated with passive loss limits of Code §469. For example, any interest taken into account in determining passive

[81] Below-the-line deductions are those that are allowed in computing taxable income after adjusted gross income has been computed.

[82] Moving expenses are, after the 1986 TRA, a below-the-line deduction. Prior to the 1986 Act, such expenses were allowed as a deduction in arriving at adjusted gross income (*i.e.*, they were an above-the-line deduction).

[83] §163(d)(2).
[84] §163(d)(3)(A).
[85] §163(d)(5).
[86] §163(d)(3)(B)(i).
[87] §163(d)(4)(A).
[88] §163(d)(4)(A).
[89] §163(d)(4)(B).
[90] §163(d)(4)(C).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

income or loss is excluded from the definition of investment interest in §163(d)(3). Also, for purposes of computing the net investment income limit on the investment interest deduction, "investment income" and "investment expense" do not include any item of income or loss taken into account under the passive loss limitation rules of §469.[91] During the four-year phase-in period of §469 passive loss rules, however, the amount of any passive loss that is allowed as a deduction will reduce the amount of investment interest that is allowable for the taxable year. A reduction in net investment income, however, will not be required for the portion of any passive loss during the phase-in period attributable to a rental real estate activity for which the taxpayer meets the active participation test.[92]

Revised §163(d) is effective for taxable years beginning after December 31, 1986. Act §511(e). The $10,000 investment interest threshold of former §163(d), however, is effectively phased out over four years. Under the phase-out, 65% of up to $10,000 (a maximum of $6,500) of investment interest otherwise disallowed by revised §163(d) is allowed for taxable years beginning in 1987. Up to $4,000 (40% of $10,000) is allowed for taxable years beginning in 1988. A maximum of $2,000 (20% of $10,000) is allowed for taxable years beginning in 1989. Finally, for taxable years beginning in 1990, up to 10% of the $10,000 amount, $1,000, is allowed. The phase-out percentage only applies to investment interest expense incurred during the phase-out year in question. Investment interest suspended in a prior taxable year and carried to another year in the phase-out period may not be taken into account.

(II) Personal Interest

Section 511(b) of the Tax Reform Act of 1986 enacted §163(h) to disallow all "personal interest" paid or accrued during the taxable year by a noncorporate taxpayer. Section 163(h)(2) defines "personal interest" as any interest allowable as a deduction for income tax purposes other than:

(i) Interest paid or accrued on debt connected with the conduct of a trade or business (but excluding debt incurred for performing services as an employee),

(ii) Any §163(d) investment interest,

(iii) Any interest taken into account under the new §469 passive loss limits,

(iv) Any "qualified residence interest" within the meaning of §163(h)(3), and

(v) Any interest payable on an estate tax deferred under §§6163 or 6166.

The foregoing definition thus treats as "personal interest" interest on debt incurred by an employee to purchase an item such as a car or computer used by the employee in the course of his employment. Personal interest also includes any interest that accrues on a tax deficiency. Excluded, however, from personal interest, is any interest subject to the revised §163(d) investment interest limits, any interest taken into account under the passive loss rules of §469, and any "qualified residence interest."

Section 163(h)(3) defines "qualified residence interest." It is interest paid or accrued during the taxable year on debt which is secured by the taxpayer's principal residence or second home at the time the interest is paid or accrued. Under §163(h)(5), the second home is the residence designated by the taxpayer for the taxable year that is used by the taxpayer or a family member for personal purposes for the greater of (i) 14 days or (ii) 10% of the number of days during the year for which the home is rented at a fair rental. If the second home is neither rented nor used as a residence at any time during a taxable year, however, the residence may be treated as the second home for the taxable year regardless of the lack of personal use.

Under §163(h)(3), "qualified residence interest" does not include any interest on debt secured by the residence to the extent that the debt exceeds the lesser of the following two amounts:

(i) The fair market value of the residence, or

(ii) The sum of (a) the taxpayer's purchase price for the residence, (b) the cost of improvements, (c) the taxpayer's qualified medical expenses, and (d) the taxpayer's qualified educational expenses.

For purposes of (ii) above, the taxpayer's purchase price for the residence will be treated as not less than the outstanding aggregate principal amount of debt which was incurred on or before August 16, 1986, and which was secured by the residence on August 16, 1986.

Except as provided in regulations, the residence interest limit is determined only as of the time debt is incurred. Thus, for example, if a residence that secures debt declines in value after the debt is incurred, interest will not be disallowed as personal interest even if the value of the residence after the decline is less than the outstanding balance of the debt.

Under §163(h)(4)(B), qualified medical expenses are amounts paid for medical care (within the meaning of §213(d)(1)(A) and (B)) of the taxpayer, his spouse, and dependents to the extent not compensated by insurance or otherwise.

Qualified educational expenses are defined by §163(h)(4)(C) as amounts paid for tuition and related expenses as well as amounts paid for reasonable living expenses while away from home of the taxpayer, his spouse, or dependent, while a student at an educational organization described in §170(b)(1).

Qualified educational expenses and qualified medical expenses must be incurred within a reasonable period of time before or after the debt is incurred for the interest on the debt to be deductible as qualified residence interest.

The 1986 TRA personal interest deduction disallowance rules apply for taxable years beginning after December 31, 1986. Act §511(e). Section 163(h)(6), however, provides a four-year phase-in for the disallowance. Under the phase-in rules, 65% of the personal interest disallowed will be allowed for taxable years beginning in 1987; 40% will be allowed for taxable years beginning in 1988; 20% for taxable years beginning in 1989; and 10% for taxable years beginning in 1990.

[91] §163(d)(4).
[92] §163(d)(4)(E).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(b) Adjustments to AMTI for Itemized Deductions

In computing AMTI, special rules apply in determining the deductibility of below-the-line itemized deductions.

(i) Miscellaneous Deductions

No miscellaneous deductions (as defined in §67(b)) are allowed in computing AMTI.[93] Consequently, to the extent a taxpayer takes a miscellaneous deduction in computing taxable income for regular tax purposes in any taxable year, his AMTI will be adjusted upward by the amount of the deduction.

(ii) Deduction for Taxes

In determining AMTI, no below-the-line deduction is allowable for the following taxes:

(i) state, local, and foreign real property taxes,

(ii) state and local personal property taxes, and

(iii) state, local, and foreign income taxes.[94]

The only taxes that may be deducted in computing AMTI include: (i) the windfall profit tax, and (ii) the generation skipping tax. Thus, to the extent a taxpayer deducts in any taxable year specified real property, personal property or income taxes in computing taxable income for regular tax purposes, his AMTI for that taxable year will be adjusted upward by the amount of the deduction.

(iii) Medical Expense Deduction

In determining AMTI, medical expenses are allowable as a deduction to the extent such expenses exceed 10% of adjusted gross income computed for regular tax purposes.[95] Since, for regular tax purposes, medical expenses are allowed as a deduction to the extent they exceed 7.5% of adjusted gross income, in certain situations such expenses deducted against regular taxable income may result in an upward adjustment to AMTI.

(iv) Interest Deduction

The interest deduction rules for AMTI purposes are more restrictive than the rules that apply for regular tax purposes. Thus, in certain situations, interest deductions may give rise to an upward adjustment to AMTI.

(I) Investment Interest

In determining AMTI, the rules that govern the deduction of investment interest for regular tax purposes apply with two modifications:

(i) the phase-in rules prescribed in §163(d)(6) do not apply;[96] and

(ii) interest on any specified activity bond and any deduction referred to in §57(a)(5)(A) is treated as includible in gross income (or as deductible) for §163(d) purposes.[97]

The non-applicability of the phase-in rules of §163(d)(6) to AMTI computations will result in an upward adjustment to AMTI if a taxpayer deducts investment interest under those rules in arriving at taxable income for regular tax purposes.

(II) Personal Interest

In determining AMTI, the rules that govern the deduction of personal interest for regular tax purposes apply with two modifications:

(i) the phase-in rules of §163(h)(6) do not apply;[98] and

(ii) in lieu of a deduction for "qualified residence interest" as defined in §163(h)(3), a deduction for "qualified housing interest" as defined in §56(e), is allowed.[99]

Qualified housing interest is defined to include interest paid or accrued by taxpayer during the taxable year on indebtedness which is incurred for purposes of acquiring, constructing, or substantially rehabilitating two types of properties:[100]

(i) property which is the principal residence of the taxpayer (within the meanings of §1034) at the time interest is paid or accrued; or

(ii) property which is taxpayer's "second home" within the meanings of §163(d)(5)(A)(i)(II).[101]

"Second home," for this purpose, includes a house, apartment, condominium, or mobile home not used on a transient basis which is designated by the taxpayer for the taxable year and which is used by the taxpayer or a family member for personal purposes for the greater of (i) 14 days or (ii) 10% of the number of days during the year for which the home is rented at a fair rental.[102]

Note: Qualified housing interest includes interest only on indebtedness incurred to acquire, construct, or substantially rehabilitate a principal residence or a second home. The mere fact that a principal residence or second home serves as security for the indebtedness is not enough to qualify interest on the indebtedness as qualified housing interest. Thus, interest on a second mortgage will not qualify as deductible qualified housing interest unless the loan proceeds are used to acquire or substantially rehabilitate a principal residence or second home.

Interest on refinanced debt which qualifies as qualified housing interest is deductible, but only to the extent the refinanced debt does not exceed the amount of original debt that is refinanced.[103]

Thus, the qualified residence interest deduction in a taxable year may be greater than qualified housing interest deduction, resulting in an upward adjustment to AMTI. Also, if a taxpayer deducts qualified residence interest under the phase-in rules in arriving at regular taxable

[93] §56(b)(1)(A)(i).
[94] §56(b)(1)(A)(ii).
[95] §56(b)(1)(B).
[96] §56(b)(1)(C)(ii).
[97] §56(b)(1)(C)(iii).
[98] §56(b)(1)(C)(ii).
[99] §56(b)(1)(C)(i).
[100] §56(e)(1).
[101] §§56(e)(1)(B) and 163(d)(5)(A).
[102] §§56(e)(2) and 163(d)(5)(A)(i)(II).
[103] §56(e)(1)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

income for a taxable year, his AMTI for that taxable year will be adjusted upward because the phase-in rules do not apply for AMTI purposes.

Note: Section 56(e)(3) grandfathers certain interest on indebtedness incurred before July 1, 1982, which did not qualify as "qualified housing interest" under the pre-TRA 1986 rules but which, nevertheless, was allowed as a deduction in arriving at AMTI.

(v) Standard Deduction

In determining AMTI, the standard deduction provided in §63(c) is not allowed.[104] Thus, a nonitemizing taxpayer who claims a standard deduction in arriving at regular taxable income will be required to adjust AMTI upwards for that year by the amount of the deduction.

(c) AMT Planning

The adjustment for itemized deductions is notable in two respects:

(i) an upward adjustment to AMTI in the current year resulting from itemized deductions is not followed by a downward adjustment to AMTI in a subsequent taxable year as is the case with some of the deferral adjustments discussed above; and

(ii) unlike any other adjustment, there is no mechanism or option available to a taxpayer to eliminate an adjustment resulting from itemized deductions.

Note, however, that itemized deductions for casualty losses under §165(c)(3), wagering losses under §165(d), and charitable contributions (other than those of appreciated property) under §170 may, theoretically at least, reduce a taxpayer's regular tax to zero without resulting in an AMT liability. The reason for this is that these deductions, along with the other deductions enumerated in §67(b), are allowable in computing AMTI.

(7) State and Foreign Tax Refunds

As stated earlier, itemized deductions for state, local, and foreign real property and income taxes, and state or local personal property taxes are not allowed in arriving at AMTI. As a corollary to this rule, any recovery of these taxes is excluded in computing AMTI.[105]

(8) Circulation and Research and Experimental Expenditures

(a) General

(i) Circulation Expenditures

Section 173 allows a taxpayer a current deduction for all expenditures to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical, for the taxable year in which such expenditures are incurred. Absent §173, expenditures to establish or increase circulation would, in all probability, have to be capitalized under §263. No current deduction, however, is allowed for expenditures incurred for the purchase of land, depreciable property, or the acquisition of circulation through the purchase of any part of the business of another publication.[106]

A taxpayer entitled to the deduction for circulation expenditures under §173 may, in lieu of taking such deduction, elect to capitalize that portion of the circulation expenditures which is properly chargeable to capital account.[107] In general, expenditures normally made from year-to-year with a view to maintaining circulation are not chargeable to capital account. On the other hand, expenditures made to establish or increase circulation are properly chargeable to capital account. For example, if a newspaper normally employs five persons to obtain renewals of subscriptions, the expenses attributable to those employees are not chargeable to capital account. If, however, the newspaper, in a special campaign to increase circulation, employs 20 additional persons for a limited time to solicit new subscriptions, these expenditures would be properly chargeable to capital account.[108] If a taxpayer makes an election with respect to expenses chargeable to capital account, such election applies to all expenditures which are so chargeable. The election, once made, is irrevocable except with the Commissioner's consent. The extent to which an amortization deduction with respect to capitalized expenditures is available will be determined under §§162, 263, and 461.[109]

(ii) Research and Experimental Expenditures

"Research and experimental expenditures" means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. It generally includes all such costs incidental to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property.[110] Expenditures by the taxpayer for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property, however, do not qualify as "research or experimental expenditures" under §174(a).[111]

Section 174(a) provides that research or experimental expenditures paid or incurred by the taxpayer during the taxable year in connection with his trade or business may be treated as expenditures which are not chargeable to capital account. The expenditures so treated are allowed as a current deduction. A taxpayer may adopt the current deduction method of §174(a) for his first taxable year without the Commissioner's consent. If, however, the taxpayer fails to adopt such method for the first taxable year in which he incurs such expenditures, he cannot do so in a subsequent year unless he obtains the Commissioner's permission.[112] If the taxpayer adopts the current deduction method of §174(a), this method applies to all research and experimental expenditures and not only taxable income for the current year, but also taxable income for all subsequent years, must be computed under this method unless the Commissioner authorizes a change of methods.[113]

[104] §56(b)(1)(E).
[105] §56(b)(1)(D).
[106] Regs. §1.173-1(a)(1).
[107] Regs. §1.173-1(c)(1).
[108] *Id.*
[109] *Id.*
[110] Regs. §1.174-2(a)(1).
[111] Regs. §1.174-2(b)(1).
[112] §174(a)(2)(B); Regs. §1.174-3(b).
[113] §174(a)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Section 174(b) provides that, in lieu of taking a current deduction under §174(a), a taxpayer may elect to capitalize and amortize research and experimental expenditures paid or incurred in connection with his trade or business provided such expenditures are: (i) properly chargeable to capital account; and (ii) not chargeable to depreciable or depletable property. Thus, the election under §174(b) is available only if the property resulting from the research and experimental expenditures has no determinable useful life. The capitalized expenditures must be amortized or depreciated over the useful life of the property.[114]

Expenditures with respect to which an election under §174(b) is in effect are allowable as a deduction over a period of not less than 60 consecutive months beginning with the month in which the taxpayer first realizes benefits from the expenditures.[115] The length of the amortization period is selected by the taxpayer at the time the election to defer the expenditures is made. The election under §174(b) to defer research and experimental expenditures applies to all such expenditures paid or incurred by the taxpayer or, if so limited by the taxpayer's election, to all such expenditures with respect to a particular project.[116]

If expenditures with respect to which the taxpayer has made a §174(b) election result in the development of depreciable (or depletable) property, the unrecovered research and experimental expenditures must be recovered as a depreciation deduction over the property's useful life.[117]

Example: For taxable year 1982, A elected to defer and deduct ratably over a 60-month period research and experimental expenditures incurred in connection with a particular project. In 1984, the total of deferred expenditures amounted to $60,000. At that time A had developed a process for which a patent was sought. On July 1, 1984, A first realized benefits from the marketing of products resulting from the process. Therefore, in his return for calendar 1984, A was entitled to an amortization deduction of $6,000. In 1985, A was entitled to an amortization deduction of $12,000. On July 1, 1986, a patent was granted to A. Consequently for calendar year 1986, A was entitled to an amortization deduction of only $6,000 and the balance of unrecovered expenditures ($60,000 - $24,000) must be amortized over the life of the patent beginning on July 1, 1986.

The §174(b) election, once made, applies to all subsequent taxable years unless a change to a different method is authorized by the Commissioner under §174(b)(2).

(b) Definition

(i) Circulation Expenditures

Circulation expenditures paid or incurred after December 31, 1986, which are deductible currently under §173 in computing regular taxable income, must be capitalized and amortized ratably over a 3-year period beginning with the year in which such expenditures are incurred in arriving at AMTI.[118] Circulation expenditures deducted under §173 will therefore result in an upward adjustment to AMTI. Thus, for example, if taxpayer deducts $45,000 under §173 in 1987, his AMTI will be adjusted upward by $30,000 because he is allowed a deduction of only (⅓ × $45,000) $15,000 for purposes of AMTI computations. The taxpayer's AMTI will, however, be adjusted downward by $15,000 in each of his taxable years 1988 and 1989, compensating him fully for the $30,000 upward adjustment to AMTI in 1987.

If the taxpayer suffers a loss with respect to circulation expenditures deducted under §173, then, for purposes of computing AMTI, the entire unamortized portion of such expenditures may be deducted in the year of the loss.[119] The amount of this deduction, however, is limited to the amount that would be allowable as a loss deduction under §165(a) if the circulation expenditure had remained capitalized.[120]

Note that, in lieu of deducting circulation expenditures under §173, the taxpayer may elect under §59(e) to capitalize and amortize such expenditures ratably over a 3-year period beginning with the taxable year in which such expenditures are incurred in computing his regular taxable income. If the taxpayer makes this election, no adjustment to AMTI will result.

(ii) Research and Experimental Expenditures

Research and experimental expenditures paid or incurred after December 31, 1986, which are deducted by the taxpayer currently under §174(a) in computing his regular taxable income, must be capitalized and amortized ratably over a 10-year period beginning with the year in which such expenditures are incurred in determining AMTI.[121] Research and experimental expenditures deducted under §174(a) will, therefore, result in an upward adjustment to AMTI. Thus, for example, if the taxpayer deducts $100,000 under §174(a) in 1987, his AMTI for 1987 will be adjusted upward by $90,000 because he is allowed a deduction of (1/10 × $100,000) = $10,000 in computing AMTI. The taxpayer's AMTI will, however, be adjusted downward by $10,000 a year in each of the subsequent nine years, compensating him fully for the $90,000 upward adjustment in 1987.

If the taxpayer suffers a loss with respect to research and experimental expenditures deducted under §174, then, for purposes of computing AMTI, the entire portion of unamortized research and experimental expenditures may be deducted in the year of the loss.[122] The amount of this deduction, however, is limited to the amount that would be allowable as a loss deduction under §165(a) if the research and experimental expenditures had remained capitalized.[123]

For purposes of computing his regular taxable income, the taxpayer, in lieu of deducting research and experimental expenditures under §174(a), may elect under §59(e) to capitalize and amortize such expenditures ratably over a

[114] Regs. §1.174-4(a)(2).
[115] Regs. §1.174-4(a)(3).
[116] Regs. §1.174-4(a)(5).
[117] Regs. §1.174-4(a)(4).

[118] §56(b)(2)(A)(i).
[119] §56(b)(2)(B)(ii).
[120] §56(b)(2)(B)(i).
[121] §56(b)(2)(A)(ii).
[122] §56(b)(2)(B)(ii).
[123] §56(b)(2)(B)(i).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

10-year period beginning with the year in which they are incurred. If this election is made, the taxpayer will have no adjustment to AMTI.

(c) AMT Planning

(i) Circulation Expenditures

In lieu of taking a current deduction under §173, the taxpayer has the option of electing to capitalize that portion of circulation expenditures which are properly chargeable to capital account.[124] Generally, expenditures incurred to maintain the circulation of a periodical are not chargeable to capital account, whereas expenditures incurred in establishing or increasing the circulation are so chargeable. The expenditures thus capitalized may be amortized, provided the taxpayer can demonstrate the limited useful life of the new subscriptions obtained.

Comment: The industry experience indicates that a magazine or a newspaper subscription typically runs for only one year and the average subscriber renews for only two or three years before dropping the subscription. It may, therefore, be possible to amortize the capitalized circulation expenditures over a 3-year period. Support for this position may be found in §59(e)(1) which permits a 3-year amortization of such expenditures.

The taxpayer also has the option of electing under §59(e) to capitalize and amortize ratably over a 3-year period all circulation expenditures.

The §173 election applies to only those expenditures which are chargeable to capital account.[125] The §59(e) election, on the other hand, may be made for all expenditures deductible currently under §173, including expenditures incurred to maintain circulation.[126]

Comment: Where the amount incurred for increasing the circulation during the taxable year is relatively small as compared to the amount expended on maintaining the circulation, an election under §173 will not help the taxpayer in eliminating upward adjustment to AMTI. In such a case, an election under §59(e) is indicated if taxpayer desires to eliminate the adjustment to AMTI.

The §59(e) election provides taxpayers with a great planning tool because it enables them to enjoy the best of both worlds, *i.e.*, capitalization under §59(e) to avoid AMT and a current deduction under §173 at the same time. For example, the taxpayer may capitalize under §59(e) just enough of the circulation expenditures necessary to avoid AMT and deduct the balance under §173.

Needless to say that before deducting circulation expenditures under §173, the taxpayer must assess the impact of such a deduction on his AMT liability. If such impact is negative he may utilize either an election under §173 or §59(e), whichever yields more favorable results.

(ii) Research and Experimental Expenditures

Under §174(b), a taxpayer may elect to capitalize and amortize ratably over a 60-month period research and experimental expenditures which are properly chargeable to capital account. If the capitalized expenditures result in depreciable or depletable property, the unrecovered expenditures must be depreciated over the property's useful life. The taxpayer may also elect under §59(e) to capitalize and amortize all research and experimental expenditures over a 10-year period. Some of the relevant considerations bearing upon a choice between these elections are summarized below.

(i) If taxpayer adopted the current deduction method of §174(a) for research and experimental expenditures incurred in a prior year, he may not make a §174(b) election for such expenditures incurred in the current year without obtaining the Commissioner's consent.[127] An election under §59(e) for the current year's expenditures may be made without such consent.

(ii) An election under §174(b) does not generally provide an amortization deduction until a year or more after the taxable year in which research and experimental expenditures are incurred. This is because, under §174(b)(1)(C), the taxpayer must wait until the first month in which he realizes benefits from the expenditures before he can begin to amortize them. An election under §59(e), on the other hand, will yield an immediate amortization deduction.

Comment: An immediate amortization deduction may or may not be desirable depending upon the tax situation of the taxpayer. For example, a taxpayer with expiring net operating loss carryovers may find an immediate deduction undesirable.

(iii) If research and experimental expenditures are not anticipated to result in depreciable or depletable property, an election under §174(b) is likely to provide a faster write-off. If, on the other hand, the research and experimental expenditures are anticipated to result in intangible depreciable property (*i.e.*, a patent), an election under §59(e) will provide a faster write-off.

(iv) An election under §174(b) applies to research and experimental expenditures paid or incurred not only in the current taxable year but also in all subsequent taxable years unless a change of method is authorized by the Commissioner.[128] An election under §59(e), on the other hand, provides more flexibility because it is a year-to-year election.

(v) An election under §174(b) applies to all research and experimental expenditures or, if so limited by the taxpayer, to all such expenditures attributable to a particular project.[129] Under no circumstances, however, can a taxpayer elect §174(b) with respect to a portion of the expenditures. An election under §59(e), on the other hand, may be made with respect to any portion of the research and experimental expenditures paid or incurred during the taxable year.[130]

Comment: The §59(e) election provides the taxpayer with a great planning tool because it enables him to enjoy

[124] Regs. §1.173-1(c)(i).
[125] *Id.*
[126] §59(e)(4)(A).
[127] Regs. §1.174-3(a).
[128] Regs. §1.174-4(a)(5).
[129] *Id.*
[130] §59(e)(4)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the best of both worlds, *i.e.*, capitalization under §59(e) to avoid AMT and a current deduction under §174(a) at the same time. For example, the taxpayer may capitalize under §59(e) just enough of the research and experimental expenditures to avoid AMT and deduct the balance under §174(a).

(9) Gain or Loss Upon Disposition of Certain Assets

As previously indicated, in the case of: (i) depreciation of real or personal property, (ii) amortization of pollution control facilities, (iii) mining development and exploration costs, and (iv) circulation and research and experimental expenditures, allowable deductions are determined for AMTI purposes under rules which are different from the rules that apply for regular tax computations. Since the AMT rules are designed to eliminate the deferral effect of the regular tax rules, AMT deductions are smaller than regular tax deductions, at least in the early years. To take into account this disparity, §59(a)(7) provides that, for purposes of computing AMTI, the adjusted basis of the types of assets described above is determined based upon the amount of deductions permitted for AMTI computations. Consequently, when an asset of the type in question is disposed of, the amount of gain or loss will be different for AMTI purposes than for regular tax purposes.

Example: A, a calendar year taxpayer, places depreciable personal property in service after December 31, 1986, at a cost of $3,000. The property has a recovery period of three years and its ADR life is four years. The following table shows the depreciation deductions available for both regular tax and AMTI purposes:

Year	*Type of Tax*	*Adjusted Basis*	*Deduction*
1987	Regular Tax	$3,000	$1,000
	AMT	3,000	563
1988	Regular Tax	2,000	1,334
	AMT	2,437	914
1989	Regular Tax	666	444
	AMT	1,523	609
1990	Regular Tax	222	222
	AMT	914	914
1991	Regular Tax	0	0
	AMT	305	305

Assuming the property is sold by A on January 1, 1989, for $4,000, A's gain for regular tax and AMT purposes is:

Regular Tax Gain = $4,000 − $666 = $3,334

AMT Gain = $4,000 − $1,523 = $2,477

(10) Disallowance of Passive Activity Losses

(a) General

Effective generally for years beginning after December 31, 1986, 1986 TRA §501 enacted Code §469 to limit the "passive activity losses" and credits of certain taxpayers. In general, a "passive activity" is any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. The taxpayers to whom the §469 limits apply include individuals, estates, trusts, personal service corporations, and (to a lesser extent) other closely held C corporations.

If a loss or credit is derived from a passive activity by one of the foregoing taxpayers (other than closely held C corporations), the loss or credit will be limited to the income generated from other passive activities. Any loss or credit not allowed by reason of the §469 limits will be available as a carryforward to future years and will generally be allowed when passive income is generated from the activity or from other passive activities or, in the case of losses, when the activity is sold or otherwise disposed of.

(i) Definition of Passive Activity

Code §469(c) defines a "passive activity" as any activity involving the conduct of any trade or business in which the taxpayer does not materially participate. A passive activity includes any rental activity, regardless of whether it constitutes a trade or business, and regardless of the taxpayer's "material participation" in the activity. If the rental activity requires the provision of substantial services, however, such as a hotel, the activity is not treated as passive so long as the taxpayer materially participates. For purposes of the passive activity definition, a trade or business includes any activity involving research or experimentation within the meaning of §174 or, to the extent provided in regulations, any activity in connection with a trade or business or any §212 income-producing activity.

Under §469(h), a taxpayer "materially participates" in an activity only if the taxpayer's involvement in the activity is regular, continuous, and substantial. In determining whether a taxpayer materially participates, the activities of a spouse will be attributed to the taxpayer. Moreover, a special rule permits a retired farmer or a surviving spouse of a farmer to be treated as a material participant if, prior to retirement or death, the farmer materially participated in the farming activity. A corporation subject to §469 is treated as materially participating if over 50% (by value) of the shareholders materially participate in the activity or if, in the case of a closely held C corporation (but not a personal services corporation), the business is an active business meets the requirements of §465(c)(7)(C)(i), (ii) and (iii).

A taxpayer is not treated as materially participating in a limited partnership to the extent of the taxpayer's interest in the partnership as a limited partner. For example, if a taxpayer holds a 25% general partnership interest and a 25% limited partnership interest in the same partnership and the taxpayer materially participates in the partnership's activities, the losses and credits allocable to the 25% limited partnership interest will be treated as passive. To prevent avoidance of the passive loss limits, regulations may be issued to override the general rule that a limited partnership interest is treated as passive.

(ii) Taxpayers Subject to Passive Limits

Section 469(a)(2) provides that the following taxpayers may be subject to the passive loss and credit limits:

(i) Any individual, estate, or trust,

(ii) Any closely held C corporation, and

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(iii) Any personal service corporation.

Under §469(e)(2), however, the passive loss and credit limits are less restrictively applied to closely held C corporations than to the other categories of taxpayers subject to the rule.

Section 469(j)(1) defines a closely held C corporation as any C corporation where, at any time during the last half of the taxable year, more than 50% in value of the outstanding stock is owned by no more than five individuals (applying the personal holding company attribution rules). A "personal service corporation" is defined as a corporation the principal activity of which is the performance of personal services that are substantially performed by employee-owners. A corporation will not be treated as a personal service corporation, however, unless more than 10% of the stock by value is held by employee-owners.

(iii) Definition of Passive Loss and Credit

Although income or loss from each passive activity must be separately accounted for, the passive activity loss for a taxable year is determined by netting the aggregate income and losses from all passive activities. If the aggregate losses exceed the aggregate income, the resulting net loss is the taxpayer's "passive activity loss." According to the Conference Report,[131] all deductions arising from passive activities, including deductions allowed under §§162, 163, 164, and 165, must be taken into account, even if claimed as an itemized deduction on the taxpayer's return. It is unclear, however, whether a charitable contribution deduction that arises from the contribution of, for example, a facade easement by a limited partnership would be subject to the passive loss rule. Interest deductions attributable to passive activities are treated as passive activity deductions and will not be treated as investment interest subject to the revised investment interest limits of §163(d).

Section 469(d)(2) defines a "passive activity credit" as the amount, if any, by which the sum of various business credits derived from passive activities exceed the taxpayer's regular tax liability for the taxable year allocable to passive activities. The credits subject to limitation as passive activity credits include:

(i) The §936 possessions credit;

(ii) The orphan drug credit;

(iii) The nonconventional fuels credit; and

(iv) The general business credit which, after 1986, includes the rehabilitation credit, the energy investment credit, the research credit, the alcohol fuels credit, the targeted jobs credit, and the low-income housing credit.

Under §469(e): (i) portfolio income (interest, dividends, annuities, royalties, and investment gains), (ii) expenses other than interest that are clearly and directly allocable to portfolio income, and (iii) interest expense properly allocable to portfolio income, are not taken into account in determining the income or loss from an activity. For this purpose, however, an interest in the passive activity is not treated as investment property so that gains and losses upon disposition of a passive activity interest will be taken into account in determining passive activity income and loss. Investment earnings on an activity's working capital will be treated as portfolio income for purposes of the foregoing rule.

Earned income will not be treated as passive income for purposes of the passive limits.

(iv) Exceptions

Section 469(e)(2) permits the passive losses of a closely held C corporation, other than a personal service corporation, to offset all income except portfolio income.

Section 469(i) provides a limited exception for individuals who actively participate in real estate activities. Under this exception, up to $25,000 of passive losses (or the amount of credit that is the deduction equivalent of the passive loss) may be used to offset nonpassive income. This $25,000 amount, however, is phased out if the taxpayer's adjusted gross income (AGI), excluding passive losses, exceeds $100,000. Under the phase-out, for every $2 of AGI above $100,000, the $25,000 amount is reduced by $1. Thus, the exception vanishes if AGI exceeds $150,000.

The $25,000 amount is available generally only if the taxpayer is a "active participant" in the rental activity. A taxpayer will not be treated as an active participant if, at any time during the taxable year, the taxpayer's interest in the activity is less than 10% by value of all interest in the activity. Moreover, a taxpayer's interest as a limited partner will not be treated as an interest with respect to which the taxpayer actively participates.

Two special rules apply to the rehabilitation and low income housing credits. First, the $25,000 amount (in a deduction-equivalent sense) is available regardless of active participation by the taxpayer. Second, the threshold for the phase-out of the $25,000 amount is raised to $200,000.

Section 469(j)(5) defines "deduction equivalent" as the amount of credits which, if allowed as a deduction, would reduce the regular tax liability for the taxable year by an amount equal to such credits. Assuming a taxpayer's taxable income is entirely subject to tax at the 28% rate and the taxpayer has no itemized deductions dependent upon the amount of the taxpayer's AGI, the deduction equivalent of credits equal to the $25,000 amount is $7,000.

(v) Suspended Passive Losses and Credits

Losses and credits not allowed under §469 are suspended until the taxpayer generates passive income from the passive activity or has income from unrelated passive activities. Under §469(g), if a taxpayer disposes of his entire interest in any passive activity in a fully taxable transaction, any suspended loss, as well as any loss arising in the year of disposition, will be allowable as follows:

(i) First, against income or gain from the passive activity for the taxable year including any gain recognized on the disposition;

(ii) Second, against net income or gain for the taxable year from other passive activities; and

(iii) Finally, against all other income or gain.

[131] H.R. Rep. No. 841, 99th Cong., 2d Sess., II-139 (1986). ("Conference Report").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

A capital loss from the disposition of the passive activity will, however, be subject to the §1211 capital loss limitations. Moreover, losses will continue to be suspended if the taxpayer transfers the interest to a related person. If the interest is sold in an installment sale, a ratable share of the suspended losses will be allowed each year in accordance with the amount of the installment sale gain reported for that year for regular tax purposes.

If a taxpayer dies, suspended losses will be allowed on the taxpayer's final return to the extent that the losses exceed the step-up in basis (to fair market value) that occurs under §1014 upon death.

Under §469(j)(6), if an interest in a passive activity is transferred by gift, the basis of the interest will be increased by the amount of the suspended losses and such losses will no longer be allowable as a deduction for any taxable year.

Section 469(j)(9) provides an election upon disposition of a passive interest under which a taxpayer may increase his basis in the passive activity by the amount of any unused credit which reduced basis of the property for the taxable year in which the credit arose. The basis increase is made as of the time immediately before the transfer. If this election is made, the passive activity credit will not be allowed in the future. If the election is not made and if the transfer does not otherwise cause recapture of the credit, the suspended credit will be allowed to offset the regular tax from the gain, if any, generated on the transfer or to offset the regular tax from passive income subsequently generated from other activities.

Under §469(f), if an activity ceases to be a passive activity, suspended passive losses and credits will be allowed as an offset against future income and future regular tax liability from active operations. Otherwise, the suspended deductions and credits continue to be treated as arising from a passive activity. Similar principles apply to a change in status of a closely held C corporation or personal service corporation.

(vi) Effective Dates and Phase-In Rules

The passive loss limits apply generally to taxable years beginning after December 31, 1986. Loss and credit carryovers from a taxable year beginning before 1987 and carried to a taxable year beginning after 1986, however, are not subject to the limits. Special transition rules apply to low-income housing. *See* Act §501(c)(3) and Act §502.

Under §469(1), the passive loss limits are phased-in over four years if (i) the taxpayer held the interest in the passive activity, or was under a binding contract to acquire the interest in the passive activity, on the date of enactment and at all times thereafter, and (ii) the passive activity was being conducted on the 1986 TRA's date of enactment or the property used in the activity was acquired pursuant to a binding written contract in effect on August 16, 1986, or construction of the property began on or before August 16, 1986. Under the phase-in, 65% of a passive activity loss and credit is allowed for taxable years beginning in 1987. This is reduced to 40% in 1988, 20% in 1989, and 10% in 1990.

(b) Definition

One rationale for the enactment of the passive loss rules of §469 is that a loss in the current year does not necessarily reflect a true economic loss, especially if it derives from an activity with future income potential. The loss can be determined with accuracy only when the activity is finally disposed of. Section 469 restricts a taxpayer's ability to defer taxes by means of passive activity losses.

The deferral that is prohibited by §469 for regular tax purposes is also prohibited by §58(b) for AMT purposes. Section 58(b) provides that, for purposes of computing AMTI, passive activity losses will be suspended. In determining the amount of loss that must be suspended in computing AMTI, the rules of §469 apply with four modifications:

(i) The adjustments of §56 shall be taken into account. Thus, for example, a taxpayer placing residential rental real estate in service in 1987 must compute his depreciation deduction for regular tax purposes by using a recovery period of 27.5 years. For purposes of computing AMTI, however, he is required to use a recovery period of 40 years. Assuming the rental activity generates a loss in 1987, the passive loss that must be suspended under §469 is determined by taking into account depreciation deductions computed over a useful life of 27.5 years, whereas a useful life of 40 years is used in determining the depreciation deduction that enters into the computation of passive activity loss that must be suspended under §58(b). Therefore, the amount of loss disallowed for AMT purposes will be smaller than the loss disallowed for regular tax purposes because of the smaller depreciation deduction.

(ii) Any deduction that is an item of tax preference under §57 shall not be taken into account. Thus, for example, if taxpayer's passive activity loss computed under §469 includes a percentage depletion deduction, such deduction will be disregarded in computing passive activity loss under §58(b). The rationale for this is that the depletion deduction is restored to AMTI under §57(a)(1) and disallowing it again under §58(b) as part of the passive activity loss would amount to double counting.

(iii) The phase-in rules of §469(l) do not apply for purposes of computing the passive activity loss that is disallowed under §58(b). Needless to say that this rule will produce serious AMT consequences to taxpayers who utilize the phase-in rules for regular tax purposes.

(iv) If a taxpayer is insolvent, the amount of passive activity loss that is disallowed under §58(b) in computing his AMTI is reduced by the amount by which taxpayer is insolvent.[132] The amount by which taxpayer is insolvent is the excess of liabilities over the fair market value of assets.[133]

In summary, the amount of passive loss that is disallowed in determining AMTI is computed after taking into account all adjustment and preference items described in

[132] §58(c)(1)(A).
[133] §58(c)(1)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

§§56-58 including the minimum tax passive farm loss adjustment discussed below.[134]

(11) Disallowance of Passive Farm Activity Loss

(a) General

From the standpoint of AMT, farming tax shelter activities are hit even harder than other passive activities. Section 58(a) subjects the losses from passive farming activities to another layer of restrictions before applying the general AMT passive activity loss limitations of §58(b). In other words, losses from passive farming activities are subject to disallowance first under §58(a). Any loss that is not disallowed under §58(a) will then be tested under the general passive activity loss limitations of §58(b) to determine the amount that is allowable in computing AMTI.

(b) Definition

For purposes of computing AMTI for any taxable year of a taxpayer (other than a corporation which is not a personal service corporation [135]), any loss deduction of such taxpayer attributable to a "tax shelter farm activity" is disallowed.[136] The amount of this passive farm activity loss that is disallowed is reduced by the amount of taxpayer's insolvency.[137] As previously indicated, the amount of the taxpayer's insolvency is the excess of his liabilities over the fair market value of his assets.[138] Any loss that is disallowed under this provision may be carried over to the first succeeding taxable year of taxpayer and treated as a deduction allocable to "tax shelter farm activity" in that year.[139] If the taxpayer disposes of his entire interest in any "tax shelter farm activity" during any taxable year, the entire amount of loss (including any carryovers) is deductible in computing AMTI for that taxable year.[140]

"Tax shelter farming activity" means:

(i) Any farming syndicate as defined in §464(c) as modified by §461(i)(4)(A).[141] A farming syndicate includes: (a) a partnership or other enterprise (other than a non-S corporation) engaged in farming if, at any time, any interest in the partnership or enterprise has been offered for sale in an offering required to be registered with any federal or state agency having authority to regulate the offering of securities for sale, (b) a partnership engaged in farming if more than 35% of the losses during any period are allocable to limited partners, and (c) any other enterprise (not including a non-S corporation) if there is an allocation of more than 35% of the losses to persons with "limited risks." Section 464(c)(2), however, provides an exception to the definition of a farming syndicate for holdings attributable to active management. Under this exception, the rules that would otherwise characterize an enterprise as a syndicate, because of a more than 35% loss allocation to limited partners or entrepreneurs, do not apply where the person to whom the loss is allocated previously actively participated in the management of any trade or business of farming for a period of not less than five years. Also, a participant is not treated as having a "limited risk" if he is an individual whose principal residence is on a farm which is farmed by the partnership or other enterprise.

(ii) Any other activity consisting of farming which is a passive activity within the meaning of §469(c) [142] but without regard to the material participation test of §469(c)(2).[143] Thus, under the second prong of the test, any farming activity not qualifying as a farming syndicate activity will, nevertheless, qualify as "tax shelter farming activity" if it is a passive activity within the meaning to §469(c) without regard to the material participation test.

Comment: The Senate Report states that, to avoid the problem of double-counting, the amount of deductions allocable to farming is determined after taking into account all adjustments and preferences (other than the adjustment for passive losses).[144] Unlike §58(b) (dealing with the regular passive loss limitation), §58(a), however, fails to make a provision for the avoidance of double-counting.

Comment: The Senate Report states that "there is no netting between different farming activities. An excess farm loss with respect to any farming activity is disallowed even if there is net income from other farming activities." Since this rule does not appear in the statute, however, it would be fair to assume that the aggregation rule of §469(d) should apply in determining the passive farm loss that is disallowed.

(12) Alternative Tax Net Operating Loss Deduction

(a) General

The final adjustment required in the AMTI computation is the substitution of the alternative tax net operating loss deduction for the regular tax net operating loss deduction.[145] Consequently, a taxpayer is required to make two parallel but distinct sets of net operating loss computations: (i) a regular tax net operating loss computation to be used in computing taxpayer's regular tax liability, and (ii) an alternative tax net operating loss computation to be used in computing taxpayer's AMT liability.

(b) Definition

The alternative tax net operating loss deduction is computed the same way as the regular tax net operating loss deduction but with two essential differences:

(i) the amount of net operating loss (within the meanings of §172(c)) for the loss year is computed: (a) by adjusting the taxable income as provided in §§56 and 58, and (b) by reducing the amount of loss by the sum of items of tax preference enumerated in §57 (except the preference for charitable contributions of appreciated property),[146] and

[134] Senate Report at 528. Note that, under §469 as finally enacted, interest allocable to passive activities is subject to the passive activity loss limitation and not the investment interest limitation.
[135] §58(a)(3).
[136] §58(a)(1)(A).
[137] §58(c)(1)(A).
[138] §58(c)(1)(B).
[139] §58(a)(1)(B).
[140] §58(c)(2).
[141] §58(a)(2)(A).
[142] §58(a)(2)(B). Although the statute refers to §469(d) it is clear that the reference is intended to be to §469(c).
[143] §58(a)(2)(B).
[144] Senate Report at 528.
[145] §56(a)(4).
[146] §§56(d)(1)(B)(i) and 56(d)(2)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(ii) for taxable years beginning after 1986, the deduction is limited to an amount which is 90% of AMTI for the taxable year in which net operating loss deduction is claimed.[147]

Comment: The modifications required to convert the regular tax net operating loss deduction into the alternative tax net operating loss deduction are basically designed to take into account the differences between the regular tax base and the AMT base. The 90% limit is designed to ensure that the net operating loss deduction does not eliminate a taxpayer's entire AMT liability for any taxable year.

Example: A, a calendar year taxpayer, in 1988 has AMTI of $10 million and a minimum tax NOL of $11 million. A may not use the NOLs to eliminate the entire $10 million of AMTI. A may use the NOL to offset only $9 million (90% of $10 million) of AMTI. The balance of $2 million in minimum tax NOL may be carried forward to 1989.

The alternative tax net operating losses may be carried back or forward in accordance with §172(b)(2). Thus, such losses may be carried back three years and forward 15. As provided in §172(b)(2), a taxpayer must carry his alternative tax NOL to the third preceding year unless an election to forego the carryback period is made under §172(b)(3)(C).[148] If the entire amount of the loss is not absorbed by AMTI for that year, the remaining loss must be carried to the second preceding taxable year. To the extent the loss is not absorbed by AMTI in such year, it must be carried to the first preceding taxable year. Any remaining loss may then be carried forward to the 15 succeeding taxable years.

Comment: An alternative tax NOL is offset to the extent of available AMTI in the carryback or carryover year even though the taxpayer owed no AMT in that year.

Example: An individual incurs an alternative tax net operating loss of $25,000 in 1990. He does not elect to forego the carryback period. In 1987, the taxpayer had an AMTI of $26,000 but owed no AMT. His $25,000 of NOL will be carried back and absorbed fully by the $26,000 of AMTI in 1987. A thus derives no minimum tax benefit from his alternative tax NOL.

Comment: A taxpayer with an alternative tax NOL should consider making an election under §172(b)(3)(C) to forego the entire carryback period if no minimum tax benefit would be derived from the carryback (*i.e.*, the taxpayer had no AMT liability in prior years). This will preserve the loss for use in future years.

(c) Effective Date

The rules discussed above apply for purposes of computing alternative tax net operating loss for taxable years beginning after December 31, 1986.[149] For purposes of computing net operating losses for taxable years beginning before January 1, 1987, that may be carried over to post-1986 years, however, the rules in effect at the time of enactment of the TRA 1986 apply.[150]

b. Items of Tax Preference

After taxable income has been adjusted as mandated by §§56 and 58, the final step in the computation of AMTI is to add back the items of tax preference described in §57.[151] Items of tax preference are essentially items of exclusion or deduction from gross income which receive preferential treatment for regular tax purposes. To neutralize this preferential treatment, these exclusions and deductions are added back to taxable income to arrive at AMTI.

The items of tax preference are summarized below.

(1) Depletion Deduction

(a) General

Section 611 permits a taxpayer a reasonable allowance for depletion in the case of mines, oil and gas wells, other natural deposits, and timber. A depletion deduction, however, is allowed to a taxpayer only if: (i) the taxpayer has an economic interest [152] in the mineral property or standing timber; (ii) the property with respect to which depletion is claimed is exhaustible; and (iii) the costs with respect to which depletion is claimed are not represented by physical property. If such costs are represented by physical property a depreciation, rather than depletion, deduction may be claimed.

The Code provides two methods for computing a depletion deduction: (i) cost depletion (§§611 and 612), and (ii) percentage depletion (§§611, 613, and 613A). A taxpayer must compute depletion under both methods and is allowed to use the method that produces the larger deduction. Note, however, that percentage depletion is not allowed with respect to timber as well as oil and gas (with certain exceptions) property. Section 613A specifies that, for taxable years beginning after 1974, percentage depletion is not available (with certain exceptions) for domestic and foreign oil and gas production. The exceptions include: (i) regulated natural gas, natural gas sold on a fixed contract, and certain geothermal deposits, and (ii) independent producers and royalty owners of domestic oil and gas.

Conceptually, cost depletion allows the taxpayer a deduction for that part of his cost (*i.e.*, the investment in the mineral property or timber) which is allocable to the mineral property (or timber) sold or otherwise used in producing the income for the taxable year. Regs. §1.611-2(a) provides that the cost depletion deduction may be computed by dividing the taxpayer's basis (as computed under §612) by the number of mineral units remaining as of the taxable year and by multiplying the result by the number of mineral units sold within the taxable year. The basis of mineral property, for cost depletion purposes, is usually the adjusted basis for determining gain or loss, and includes any oil and gas drilling and development costs which have been capitalized (Regs. §1.612-1(b)(1)). Since depletion deductions reduce the taxpayer's basis in the

[147] §56(d)(1)(A).
[148] Conference Report, p. II-262.
[149] §56(d)(2)(A).
[150] §701(f)(2)(A) of the Act.
[151] §55(b)(2).
[152] For a definition of "economic interest" *see* Regs. §1.611-1(b)(1).

mineral property, cost depletion is no longer available once the taxpayer's basis has been reduced to zero.

As indicated above, the purpose behind cost depletion is to allow the taxpayer to recoup his investment in the mineral property on a tax-free basis. Percentage depletion, on the other hand, is an arbitrary allowance totally unrelated to the taxpayer's investment in the mineral property. It is computed as a specified percentage of gross income from the mineral property, subject to a ceiling of 50% of the taxable income from the property (computed without regard to the depletion deduction). The applicable percentages for various mineral properties are specified in §613(b). Since percentage depletion is based on gross income from the mineral property, it may be claimed as long as the property produces gross income. Thus, it offers the possibility of recovering, as a depletion allowance, an amount far in excess of the taxpayer's investment in the property. For this reason, investment in hard minerals and, to a certain extent, in oil and gas, has been a popular way for many taxpayers to produce a flow of tax-free cash. By the same token, percentage depletion has long been a favorite target of those seeking to close tax loopholes. Over the years, Congress has attacked this "tax-shelter" both directly [153] — by reducing the allowable depletion percentages — and indirectly by enacting this item of tax preference.

(b) Definition

The excess of the depletion deduction allowable [154] over the adjusted basis [155] of the property at the end of the year, disregarding the current year's depletion deduction, is an item of tax preference.[156] The excess is computed on each separate "property" as defined for depletion purposes.[157] Accordingly, basis in one property will not reduce excess depletion in connection with another.

The adjusted basis of the property at the end of the taxable year is determined under §1016 and the regulations thereunder. No adjustment is made to the basis of property subject to depletion as a result of the minimum tax.[158]

The preference is measured on a cumulative basis. Depletion will not be considered an item of tax preference until the total depletion deductions have exceeded the adjusted basis of the property. Then, the entire amount of the percentage depletion in excess of that basis will be considered an item of tax preference.

(2) The Intangible Drilling and Development Costs (IDCs)

(a) General

With respect to intangible drilling and development costs incurred in the development of oil and gas properties, the taxpayer has an option to either capitalize or currently expense such costs.[159] The statutory authority for currently expensing the IDCs is provided in §263(c). The IDCs are those costs which, in and of themselves, have no salvage value. These include amounts paid for labor, fuel, repairs, hauling and supplies, or any of them, which are used: (i) in the drilling, shooting, and cleaning of wells; (ii) in such cleaning of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and (iii) in construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.[160] IDCs also include the cost of installing tangible equipment necessary for the drilling of wells and for preparing wells for production (although the equipment itself must be capitalized and depreciated). A well is considered complete when casing and a "Christmas Tree" have been installed. IDCs, however, do not include labor, supplies etc. used to install production facilities. For example, a taxpayer may not elect, under §263(c), to expense the following costs: (i) oil well pumps (on the initial completion of the well, and after the well has flowed for a time) including the necessary housing structures; (ii) oil well separators including the housing structures; (iii) pipelines from the wellhead to oil storage tanks as well as the oil storage tanks on the producing lease; (iv) salt water disposal equipment and recycling equipment; and (v) pipelines from the oil storage tanks on the producing leasehold to a common carrier pipeline.[161] In addition, the option to capitalize or currently expense IDCs is not available with respect to capital items. For example, the costs of materials used in structures constructed in the wells, drilling tools, pipe, casing, tubing, tanks, engines, boilers, etc. must be capitalized and depreciated.[162] By the same token, expenditures which must be charged off as expense may not be capitalized. Examples of such expenditures are costs of labor, fuel, repairs, hauling, supplies, etc. incurred in connection with the operation of the wells and of other facilities on the property for the production of oil and gas.[163]

IDCs that are capitalized, but which relate to a nonproductive well may, at the taxpayer's election, be deducted as an ordinary loss in the taxable year in which the nonproductive well is completed.[164] The capitalized IDCs relating to a productive well, on the other hand, may be recovered through depletion, provided such costs are not represented by physical property.[165] Examples of such costs include ground clearing, draining, road making, surveying, geological work, excavation, grading, drilling, shooting, and cleaning of wells. If the capitalized IDCs are represented by physical property, such costs must be recovered through depreciation.[166] Examples of such costs include amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the premises of derricks and other physical structures.

---

[153] §613A.
[154] Regs. §1.57-1(h)(2); *See also* §611 and Regs. §1.611-1(a).
[155] §§1011, 1012, 1016(a)(2) and Regs. §1.57-1(h)(3).
[156] §57(a)(1).
[157] §§57(a)(1) and 614. Under §614, however, mining interests may be aggregated. Aggregated properties constitute a single property.
[158] Regs. §1.57-1(h)(4).
[159] Regs. §1.612-4(a).
[160] *Id.*
[161] Rev. Rul. 70-414, 1970-2 C.B. 132.
[162] Regs. §1.612-4(c)(1).
[163] Regs. §1.612-4(c)(2).
[164] Regs. §1.612-4(b)(4).
[165] Regs. §1.612-4(b)(1).
[166] Regs. §1.612-4(b)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The rules described above relating to IDCs incurred in developing oil and gas properties also generally apply to IDCs incurred in developing geothermal deposits. Section 613(e)(3) defines a geothermal deposit as a "geothermal reservoir consisting of natural heat which is stored in rocks or in an acqueous liquid or vapor (whether or not under pressure)." Percentage depletion is allowed with respect to a geothermal deposit and such a deposit is not treated as a gas well for purposes of the limits on percentage depletion provided in §613A.

As stated above, under §263(c), costs that normally would be required to be capitalized are allowed as a current deduction provided the taxpayer so elects. This election provides the taxpayer with a timing benefit, allowing him to deduct immediately the costs incurred rather than deducting them over the life of the well or the equipment.

(b) Definition

The IDCs tax preference is defined as the excess of the excess intangible drilling and development costs for the taxable year over 65% of the taxpayer's net income from oil, gas, and geothermal properties for that taxable year.[167] The IDC tax preference amount, however, is computed separately for oil and gas and geothermal properties.[168]

For purposes of computing the IDC tax preference, excess IDCs are defined as the excess of the amount of intangible drilling and development costs paid or incurred with respect to oil, gas, (or geothermal) properties that the taxpayer elects to expense under §263(c) over the amount that would be allowed for the taxable year if the costs had been capitalized and amortized under one of the methods provided in §57(b).[169] Section 57(b), in turn, provides for: (i) a ratable amortization over a 120-month period beginning with the first month in which the production begins, or (ii) at the election of the taxpayer, any method permitted for determining cost depletion with respect to a well.

The net income from oil and gas (or geothermal) properties is defined as the gross income from all the taxpayer's oil, gas (or geothermal) properties, less any deductions allocable to these properties reduced by the excess intangible drilling and development costs.[170]

Comment: Since deductions specifically allocable to the properties producing gross income are allowed in computing the net income from oil, gas, (or geothermal) properties, deductions allocable to wells that turn out to be nonproductive will not offset gross income derived from productive wells.

The following example illustrates the computation of the IDC preference.

Example: The taxpayer, owning an economic interest in certain oil and gas properties, incurs $50,000 in IDCs during 1984, and elects to take a current deduction for these costs under §263(c). During 1984 the taxpayer derives $40,000 gross income from the property and incurs $15,000 in operating expenses. The taxpayer's IDC tax preference is computed as follows:

1. Calculation of Excess IDCs:	
IDCs currently deducted	$50,000
Less	
Allowed amortization deduction under §57(b)(1) (assuming the production begins in the 7th month of the year).	2,500
Excess IDCs	$47,500
2. Calculation of Net Income:	
Gross Income	$40,000
Less	
Allocable deductions	
IDCs	$50,000
Depletion	$ 6,000
Operating expenses	$15,000
Total Allocable Expenses	$71,000
Less	
Excess IDCs	$47,500
	$23,500
Net Income (GI less EIDCs)	$16,500
3. Calculation of IDC Tax Preference:	
Excess IDCs	$47,500
Less	
65% of Net Income	$10,725
Preference Amount	$36,775

Note, however, that IDCs incurred with respect to nonproductive wells do not give rise to a tax preference item. Under §57(a)(2)(B), such IDCs are disregarded in computing the excess IDCs. Nonproductive wells are those which are plugged and abandoned without having produced oil and gas in commercial quantities for any substantial period of time. Therefore, a plugged and abandoned well may have produced some oil and still be considered nonproductive, depending on the ratio of oil produced to costs of drilling.[171] The IDCs attributable to a nonproductive well may, at the taxpayer's election, be either capitalized or deducted currently as a loss, provided the taxpayer has not elected to deduct the IDCs currently under §263(c).

Consequently, a taxpayer will need to determine at the close of the taxable year, or at least by the time for filing the return, whether a well is productive. If the well is not determined to be nonproductive by the time the return is required to be filed, the IDCs with respect to it will be subject to AMT.[172] The taxpayer may, however, later file an amended return and claim a refund for the amount of minimum tax paid with respect to the well if it subsequently proves to be nonproductive.[173]

[167] §57(a)(2)(A).
[168] §57(a)(2)(D).
[169] §57(a)(2)(B).
[170] §57(a)(2)(C).
[171] Conference Rep. on H.R. 10612, 122 Cong. Rec. 9928 (Sept. 13, 1976), 94th Cong. 2d Sess. (1976).
[172] *Id.*
[173] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(c) Election Under §57(b)(2)

For purposes of computing the excess IDCs, a taxpayer may use either the 120-month period prescribed in §57(b)(1) or elect, under §57(b)(2), to use the cost depletion method. If the taxpayer elects cost depletion, this election must be made within the time prescribed for filing the taxpayer's tax return (including extensions) for the taxable year in which the IDCs are paid or incurred.[174] The cost depletion election must be made for each well separately.[175] Thus, a taxpayer may make the cost depletion election for some of his wells. Additionally, for purposes of computing the excess IDCs, the taxpayer may make the cost depletion election even if he uses some other method for computing his taxable income.[176] In the case of a partnership, the §57(b)(2) election must be made at the partnership level.[177]

In computing the cost depletion pursuant to a §57(b)(2) election, both depletable and depreciable IDCs are taken into account.[178] Depletable IDCs are those costs which are not represented by physical property (*e.g.*, costs incurred in ground clearing, draining, geological work, excavation, grading, etc.). Depreciable IDCs are those costs which are represented by physical property (*e.g.*, wages, fuels, supplies, etc., used in the installation of casing, equipment, and physical structures). The depletable and depreciable IDCs are treated as if capitalized, added to basis, and recovered under Regs. §1.611-2(a) (dealing with the cost depletion method). Note, however, that, in computing cost depletion pursuant to a §57(b)(2) election, only IDCs paid or incurred in the current year are taken into account.[179]

(d) Section 59(e) Election

Under §59(e), a taxpayer may elect to deduct IDCs ratably over a 10-year period beginning with the taxable year in which the IDCs are paid or incurred. If the taxpayer makes an election under §59(e), no preference amount will result from IDCs.[180]

(e) AMT Planning

Capitalization of IDCs under both Regs. §1.612-4 and §59(e) enable a taxpayer to eliminate the tax preference amount. The pros and cons of the two elections discussed below must be examined carefully to make an appropriate choice.

(i) Under the Regs. §1.612-4 election, the capitalized IDCs are recovered through depletion (if the expenditures do not result in physical property) or through depreciation (if the expenditures result in physical property) over the life of the well or equipment. Under §59(e) election, on the other hand, IDCs are amortized ratably over a 10-year period beginning with the taxable year in which the IDCs are paid or incurred. The taxpayer may choose the option that provides the longer or the shorter recovery period, depending upon his situation.

(ii) An election under Regs. §1.612-4 to capitalize IDCs is binding for all subsequent taxable years.[181] Consequently, a taxpayer may not shift between the current deduction method and the capitalization method from year-to-year. The §59(e) election, on the other hand, is not binding on subsequent taxable years. Thus, if a taxpayer made an election under §59(e) for the current year, IDCs paid or incurred in a subsequent taxable year may be deducted under §263(c).

Comment: There is a certain amount of tension between the Regs. §1.612-4 election and the §59(e) election. If a taxpayer makes a Regs. §1.612-4 election, he may not deduct IDCs paid or incurred in a subsequent taxable year under §263(c). If, however, the taxpayer is permitted to make an election under §59(e) with respect to IDCs paid or incurred in a subsequent taxable year, this would enable him to deduct a portion of such costs under §263(c).

(iii) If the taxpayer claims percentage depletion, capitalization of IDCs under Regs. §1.612-4 will not yield any additional deduction. Capitalization of IDCs under §59(e), however, will yield an additional deduction for regular tax purposes.

(iv) An election under Regs. §1.612-4 applies to all IDCs paid or incurred with respect to all properties not only in the current year but also in all subsequent years.[182] An election under §59(e), on the other hand, may be made with respect to any portion of IDCs paid or incurred during the taxable year.[183]

Comment: Since a taxpayer may elect to capitalize any portion of IDCs under §59(e) and deduct the rest under §263(c), §59(e) provides him with a planning tool to maximize the regular tax benefit of current deduction under §263(c) while avoiding AMT liability.

(v) If the IDCs are capitalized and amortized pursuant to a §59(e) election, the deducted expenditures shall, upon a subsequent disposition of the property, be recaptured as ordinary income under §1254. No such recapture, however, is required if the IDCs are capitalized in accordance with Regs. §1.612-4.

Comment: The significance of recapture under §1254 is considerably reduced after 1987 because of the elimination of the tax rate differential between ordinary income and capital gain.

(3) Incentive Stock Options

(a) General

Incentive stock options governed by §422A offer two tax benefits: the possibility of converting ordinary income into capital gain to the extent of the difference between the option price and the fair market value of stock at the time of exercise, and the deferral of recognition of gain until the time of disposition. The significance of the conversion

[174] Temp. Regs. §7.57(d)-1(b)(1).
[175] Temp. Regs. §7.57(d)-1(b)(2).
[176] Temp. Regs. §7.57(d)-1(b)(4).
[177] Temp. Regs. §7.57(d)-1(b)(5).
[178] Temp. Regs. §7.57(d)-1(c).
[179] *Id.*
[180] §59(e)(6).
[181] Regs. §1.612-4(e).
[182] *Id.*
[183] §59(e)(4)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

benefit was reduced considerably for post-1987 years because of the 1986 TRA's elimination of the tax rate differential between ordinary income and capital gain. The regular tax benefit of deferral was also reduced by the imposition of AMT on the deferral amount.

(b) Definition

Upon transfer of a share of stock pursuant to the exercise of an incentive stock option (ISO), the excess of the stock's fair market value at the time of exercise over the option price is an item of tax preference.[184] For purposes of determining the fair market value of a share of stock, any restriction, other than a restriction which by its own terms will never lapse, is disregarded.

Example: Taxpayer, a key executive in a corporation is granted an option in 1986 to purchase a maximum of 10,000 shares for $10 per share. He purchases 10,000 shares in 1987 when the fair market value of the corporation's stock is $15 per share. The preference amount for 1987 is calculated as follows:

Fair Market Value (per share)	
At the Time of Exercise	$15
Less Option Price	$10
Preference Amount (per share)	$ 5

Total Preference Amount — 10,000 × $5 = $50,000

This preference amount will not again be included in AMTI in the year the taxpayer disposes of the stock.[185] This result is achieved by adding the preference amount included in AMTI in the year of exercise to the basis of the stock. Thus, in the above example, the taxpayer's basis in the optioned stock will be $15 per share for purposes of computing gain to be included in AMTI upon ultimate disposition of the stock.

(4) Tax-Exempt Interest

(a) General

The Tax Reform Act of 1986 restructured the Code provisions dealing with tax-exempt bonds, imposed new restrictions and extended many existing restrictions.[186] Sections 103 and 103A of the 1954 Code were reorganized into 11 1986 Code sections: §103 and §§141-150. The Act changed the exempt financing lexicon by substituting the term "private activity bonds" for "industrial development bonds". Interest on a private activity bond is taxable unless the bond is a qualified bond.[187] Qualified bonds, the interest on which is tax-exempt, include:

(i) Qualified Exempt Facility Bonds (§142),

(ii) Qualified Mortgage Revenue Bonds (§143),

(iii) Qualified Small Issue Bonds (§144(a)),

(iv) Qualified Student Loan Bonds (§144(b)),

(v) Qualified Redevelopment Bonds (§144(c)),

(vi) Qualified §501(c)(3) Bonds (§145(a)).

Code §147 contains several restrictions on private activity bonds that previously applied to industrial development bonds. The substantial user requirement, the 120% bond maturity limit, the 25% limit on land acquisition cost, the existing property acquisition rules, the prohibition against use of bond proceeds for skyboxes, airplanes, gambling establishments, etc., and the public approval requirements carryover from the pre-1986 Act law. The 1986 Act extended the 120% bond maturity limit to §501(c)(3) bonds. The prohibition for skyboxes, airplanes, gambling establishments, etc., was extended to all private activity bonds except health facilities owned by §501(c)(3) organizations. Section 147(g), as enacted by the TRA, provides a 2% cap on the amount of proceeds which can be spent for cost of issuance of the bonds.

The registration requirement and federal guaranty prohibition were carried over from pre-TRA law into Code §149. The information reporting requirement was extended to all tax-exempt bonds. Section 149(d) extends the prohibition on advance refunds to all private activity bonds except §501(c)(3) bonds.

Also, under 1986 Code §265(b), banks and other financial institutions may not deduct interest expense allocable to tax-exempt interest on bonds acquired after August 7, 1986.

(b) Definition

Interest on "specified private activity bonds" issued after August 7, 1986, is an item of tax preference.[188] Specified private activity bonds include all "private activity bonds" as defined in §141 of the Code with the following exceptions:

(i) The term "private activity bond" does not include Qualified §501(c)(3) Bonds as defined in Code §145;[189] and

(ii) The term "private activity bond" does not include any refunding bond if the refunded bond (or, in the case of a series of refundings, the original bond) was issued before August 8, 1986.[190] For this purpose, bonds issued before September 1, 1986, which are covered under the Joint Statement on Effective Dates of March 14, 1986, are considered to have been issued before August 8, 1986.[191] The Joint Statement provided generally that interest on bonds satisfying the pre-TRA 1986 definition of governmental bonds (as modified by an expanded security interest test like that adopted under the Senate Amendment) is not a preference if bonds are issued before September 1, 1986.

Thus, interest on Qualified Small Issue Bonds, Qualified Mortgage Revenue Bonds, Qualified Small Issue Bonds, Qualified Student Loan Bonds, and Qualified Redevelopment Bonds, which is exempt from tax for regular tax purposes, is includible in AMTI as an item of tax preference.

[184] §57(a)(3)(A).
[185] §57(a)(3)(B).
[186] For a discussion of the changes, *see* Chapter 30, *supra*.
[187] §103(b)(1).
[188] §57(a)(5)(a).
[189] §57(a)(5)(C)(ii).
[190] §57(a)(5)(C)(iii).
[191] §57(a)(5)(C)(iv).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

In the case of tax-exempt interest dividends paid by a regulated investment company, the shareholders are required to include a portion of such dividends, to be determined under regulations to be prescribed by the Secretary, in AMTI as an item of tax preference.[192]

Finally, note that tax-exempt interest which is required to be included in AMTI under §57(a)(5)(A) may be reduced by allocable interest deductions disallowed under §265(b) for regular tax purposes.

(5) Charitable Contributions of Appreciated Property

(a) General

For income tax purposes, an individual, whether or not he itemizes his deductions, is allowed a charitable contribution deduction from adjusted gross income if he satisfied the requirements of §170 and other relevant Code sections. Generally, a contribution is deductible only if it is made to or for the use of a permissible donee as described in §170(c). In addition, §170(b) provides detailed rules limiting the deduction for charitable contributions. Broadly speaking, an individual donor may be limited in any one year to a deduction not in excess of 20%, 30%, or 50% of his "contribution base," defined by §170(b)(1)(F) as adjusted gross income computed without regard to any net operating loss carryback to the relevant taxable year.

The 50% limit applies to cash and ordinary income property contributions to public charities and private operating foundations (as defined in §4942(j)(3)).[193] The 50% limit also applies to contributions made to a nonoperating foundation provided it: either (i) qualifies as a "pooled fund" foundation,[194] or (ii) redistributes all contributions within a specified time period.[195]

The 30% limit applies to contributions made either to those nonoperating foundations which do not qualify for the 50% limit or, for the use of a charity.[196] The 30% limitation also applies to contributions of capital gains property made to those organizations which qualify for the 50% limitation.[197]

Note: Prior to the Tax Reform Act of 1984, contributions made to nonoperating foundations (other than those which were subject to the 50% limit) were subject to a 20% limit. For contributions made in taxable years ending after July 18, 1984, however, the TRA 1984 increased the limit to 30%.

The 20% limit applies to gifts of capital gain property made to organizations which do not qualify for the 50% limit.[198]

Note: The 50% limit is also an overall limitation which applies to all contributions. For purposes of computing this limit, contributions to public charities and private operating foundations are considered before contributions to nonoperating foundations or contributions for the use of charities are taken into account.[199] Thus, if a taxpayer makes contributions equal to 50% of his contribution base to a public charity in a taxable year, no contributions to a nonoperating foundation would be deductible in that taxable year. Contributions of capital gain property subject to the 30% limit are taken into account after all other charitable contributions (except capital gain property contributions subject to the 20% limit).[200] Contributions of capital gain property which are subject to the 20% limit are taken into account after all other charitable contributions have been considered.[201]

Any charitable contribution which is not deductible in a given taxable year under the limits described above, may be carried forward to the following five taxable years.[202]

The rules that apply to charitable contributions of appreciated property are summarized below.

(i) If the contributed property is ordinary income property (*i.e.,* property that would produce ordinary income if sold), the amount of deduction allowable for the taxable year is computed by applying the 50% or 30% limit to the property's adjusted basis.[203] In other words, the amount that is considered contributed to the charity is equal to the adjusted basis of the property. Examples of ordinary income property include inventory, stock-intrade, works of art created by the donor and other short-term capital assets.

(ii) If the contributed property is capital gain property (*i.e.,* property that would produce long-term capital gain if sold), as a general rule, the 30% or 20% limits applicable to capital gains property are applied to the full fair market value of the property in order to determine the allowable deduction for the taxable year. In other words, the contributions of capital gain property are taken into account at their full fair market value as a general rule. If, however, the contribution is made to a charity which is subject to 30% limit, or if the gift is of tangible personal property put to a use that is unrelated to the purpose or function upon which the donee's exemption is based, the donor must reduce the amount of contribution by 40% of the built-in gain (*i.e.,* the amount by which the fair market value of the property exceeds its adjusted basis).[204]

The taxpayer may also elect to reduce the amount of contribution by 40% of the built-in gain, in which case the 50% limit rather than the 30% limit will apply to his contribution of capital gain property.[205]

(b) Definition

For charitable contributions of "capital gain property," the amount by which the deduction allowable under §170 would be reduced if all "capital gain property" were taken into account at its adjusted basis, is an item of tax preference.[206] As indicated above, "capital gain property" means

[192] §57(a)(5)(B).
[193] §170(b)(1)(A).
[194] §170(b)(1)(E)(iii).
[195] §170(b)(1)(E)(ii).
[196] §170(b)(1)(B).
[197] §170(b)(1)(C)(i).
[198] §170 (B)(1)(D)(i).
[199] §170(b)(1)(B)(ii).
[200] §170(b)(1)(C)(i).
[201] §170(b)(1)(D)(i).
[202] §§170(d)(1), 170(b)(1)(B), 170(b)(1)(C)(ii) and 170(b)(1)(D)(ii).
[203] §170(e)(1)(A).
[204] §170(e)(1)(B). Note, however, that the 40% reduction requirement does not apply to contributions of qualified appreciated stock as provided in §170(e)(5).
[205] §170(b)(1)(C)(iii).
[206] §57(a)(6)(A).

any capital asset (including §1231 assets) the sale of which would result in a long-term capital gain.[207] "Capital gain property," however, does not include any property for which the taxpayer makes an election under §170(b)(1)(C)(iii) to apply the rules of §170(e)(1).[208] Thus, where the taxpayer elects to reduce the amount of contribution by 40% of the built-in gain, the preference does not apply.

In determining the amount of preference for charitable contributions of capital gain property, the following rules apply:

(i) The taxpayer computes the amount by which the charitable deduction would have been reduced by taking into account all capital gain property (including loss property) into account at its adjusted basis. Thus, unrealized gain on appreciated property is offset by unrealized loss on the loss property.

(ii) The amount of preference is determined by disregarding any amount that is carried forward to another year for regular tax purposes.[209] Consequently, if a portion of a charitable contribution deduction is carried forward because it exceeds the applicable limit, the portion so carried forward will not increase the amount of preference until it is allowed as a deduction for regular tax purposes.

(iii) The preference does not apply to carryovers of the deduction with respect to charitable contributions made before August 16, 1986.[210]

Example: A, a calendar year taxpayer, makes a contribution of capital gain property to a church in 1987 which is subject to the 30% limit. At the time of contribution, the fair market value of the property is $50,000 and its adjusted basis is $40,000. For 1987, A's adjusted gross income is $100,000. The amount of allowable deduction for 1987 is, therefore 30% of $100,000, or $30,000. Consequently, for regular tax purposes, A may deduct $30,000 in 1987 and carry over the balance of $20,000 to 1988. To compute the preference amount for 1987, however, the amount of deduction is limited to its adjusted basis. Using a pro rata allocation of adjusted basis rule, the $30,000 charitable contribution deductible in 1987 has an adjusted basis of 30,000 ÷ 50,000 × $40,000 = $24,000. Consequently, the amount of preference for 1987 is $30,000 − $24,000 = $6,000.

(c) AMT Planning

A taxpayer considering a gift of capital gain property to charity may have one or two options available to him to eliminate the amount of tax preference attributable to such a gift. For example, the taxpayer may own "capital gain property" the fair market value of which is less than its adjusted basis. If so, the taxpayer may combine such property with appreciated "capital gain property" in his gift to charity. The built-in loss will offset (wholly or partially) the built-in gain, thus eliminating (wholly or partially) the preference amount. Alternatively, the taxpayer may consider an election under §170(b)(1)(C)(iii) to reduce the built-in gain by 40%. If this election is made, the preference for contributions of "capital gain property" does not apply.

Example: Assume the same facts as in the Example in the preceding section. A makes an election under §170(b)(1)(C)(iii) to reduce the built-in gain by 40%. Thus, for regular tax purposes, the amount of contribution is reduced by 40% of $10,000 ($4,000) to $46,000. As a result of the election, however, A's deduction limit is also increased to (50% of $100,000) = $50,000 in 1987. Consequently, for regular tax purposes, A may deduct the entire $46,000 in 1987 with no carryovers and no tax preference amount. Note that, in addition to eliminating the preference amount, A also gets a significantly larger deduction against regular tax in 1987. All this is at a cost of a $4,000 reduction in the total amount of contribution.

Comment: The advisability of an election under §170(b)(1)(C)(iii) will turn upon the taxpayer's ability to absorb larger deductions against regular taxable income and upon the amount of built-in gain. If the amount of built-in gain is too large, the cost of such an election may not be worth the benefits.

(6) ACRS and Amortization on Property Placed in Service Before 1987

For property placed in service before January 1, 1987 (to which §§56(a)(1) and 56(a)(5) do not apply), the amount computed under §§57(a)(2), 57(a)(3), 57(a)(4) and 57(a)(12), as in effect prior to the enactment of TRA 1986, remains an item of tax preference.[211]

Section 57(a)(2) dealt with the preference amounts with respect to non-ACRS deductions taken on real property.

Under that provision, the excess of accelerated depreciation deductions allowable with respect to each §1250 property for the taxable year over the amount that would be allowable as a deduction for that taxable year if the taxpayer depreciated the property using a straight-line method for each taxable year of the property's useful life, constituted an amount of tax preference.

Section 57(a)(3) dealt with the preference amounts with respect to non-ACRS accelerated depreciations deductions taken on leased personal property. Under that provision, the excess of accelerated depreciation deduction allowable with respect to each §1245 leased property for the taxable year over the amount that would be allowable as a deduction for the taxable year if the taxpayer depreciated the property using a straight-line method for each taxable year of the property's useful life, constituted an amount of tax preference.

Section 57(a)(4) dealt with the preference amounts with respect to amortization of pollution control facilities. Under that provision, the excess of amortization deductions allowable for the taxable year under the 60-month write-off

[207] §170(b)(1)(C)(iv).
[208] §57(a)(6)(B).
[209] House Report at 313.
[210] §701(f)(4).
[211] §57(a)(7).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

election provided by §169 over the amount that would otherwise be allowable as a deduction under §167 or §168 constituted an amount of tax preference.

Section 57(a)(12)(A) dealt with preference amounts relating to ACRS depreciation deductions taken on leased recovery property (other than 19-year real property and low income housing). Under that provision, the excess of the deduction allowed under §168(a) for the taxable year over the deduction that would be allowed if the taxpayer used the straight-line method over a recovery period specified in the following table, constituted an item of tax preference.

Type of Property	*AMT Recovery Period*
3-year Property	5 years
5-year Property	8 years
10-year Property	15 years
15-year Public Utility Property	22 years

Section 57(a)(12)(B) dealt with preference amounts relating to ACRS deductions taken on 19-year real property or low income housing. Under that provision, the excess of ACRS deductions for each 19-year real property on low income housing property allowed under §168(a) for the taxable year over the amount that would be allowed if the taxpayer depreciated the property using the straight-line method over 19 years for real property, and 15 years for low income housing constituted an item of tax preference.

c. Coordination With Certain Limitations

Section 59(h) provides that in computing AMTI of a taxpayer for a taxable year, certain Code limits on the deductibility of losses will be applied by taking §56 adjustments into account and by disregarding any deductions which are items of tax preference under §57.

The limits specified in §59(h) include §465, §704(d) and §1366(d). Section 465 provides that an individual or a C corporation engaged in an activity covered by that section may deduct a loss only to the extent of the aggregate amount with respect to which taxpayer is at risk. Section 704(d) provides that a partner's distributive share of partnership loss shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of partnership's taxable year in which the loss occurred. Section 1366(d) provides a similar rule for shareholders of S corporations. Section 59(h) authorizes the Treasury to specify by regulations other Code provisions which are subject to this coordinating rule.

d. Optional 10-Year Write-Off of Certain Adjustments and Preferences

(1) General

With respect to certain capital expenditures for which the Code provides preferential treatment (*i.e.*, a current deduction) and which are designated as items of adjustment or preference under §§56 and 57, respectively, §59(e) provides the taxpayer, if he chooses, an option to elect a capital treatment and eliminate the adjustment or preference amount. Note that the §59(e) election is an added luxury in that all expenditures subject to this election may be deferred or capitalized under other Code provisions. Thus, a taxpayer desiring to eliminate the preference amount may choose between capital treatment under §59(e) and capital treatment under other Code provisions.

If an election is made under §59(e) with respect to an expenditure, the expenditure is capitalized and amortized in accordance with §59(e) for all purposes of the Code, and not just §55 purposes. Accordingly, once an election under §59(e) is made with respect to an expenditure, the expenditure is amortized under §59(e) for both regular tax and AMT purposes and no deduction is allowed under any other Code section.[212] Any amount to which an election under §59(e) applies is not treated as an item of adjustment under §56 or an item of tax preference under §57.[213]

(2) The Election

An election under §59(e) may be made only with respect to "qualified expenditures." "Qualified expenditures" means any amount that would, absent a §59(e) election, be allowable as a deduction in the year paid or incurred under:

(i) Section 173 (relating to circulation expenditures)

(ii) Section 174(a) (relating to research and experimental expenditures)

(iii) Section 263(c) (relating to IDCs)

(iv) Section 616(a) (relating to mining development expenditures), or

(v) Section 617(a) (relating to mining exploration expenditures).[214]

If an election under §59(e) is made with respect to circulation expenditures deductible currently under §173, such expenditures are capitalized and amortized ratably over a three-year period beginning with the taxable year in which they are paid or incurred.[215] On the other hand, if a §59(e) election is made with respect to any other qualified expenditure, the expenditure must be capitalized and amortized ratably over a 10-year period beginning with the taxable year in which the expenditures were paid or incurred.[216]

Section 59(e)(4)(A) provides that an election under §59(e) may be made with respect to any portion of a qualified expenditure. This implies that, if a taxpayer chooses to capitalize only a portion of a qualified expenditure, *e.g.*, circulation expenditures, paid or incurred during a taxable year, the balance may be deducted currently under the applicable Code provision (§173 in the case of circulation expenditures). This creates a tension between §59 and other Code or regulatory provisions which govern the capitalization of qualified expenditures. For example, an election to capitalize circulation expenditures under §173 applies to all such expenditures chargeable to capital account. Similarly, an election to capitalize research and experimental expenditures under §174(b) applies to all

[212] §59(e)(3).
[213] §59(e)(6).
[214] §59(e)(2).
[215] §59(e)(1).
[216] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

research and experimental expenditures (or, if so limited by the taxpayer, to all research and experimental expenditures attributable to a particular project) paid or incurred during the taxable year. The exercise of an option to defer and capitalize the mining exploration costs applies to all such costs paid or incurred during the taxable year. An election under §616(b) to capitalize the mining development costs applies to all such costs paid or incurred during the taxable year on a mine-by-mine basis. Finally, an election to capitalize the IDCs under Regs. §1.612-4 applies to all such costs paid or incurred during the taxable year with respect to all properties. Since §59(e)(3) expressly precludes the application of any other Code section to the amount with respect to which a §59(e) election is made, however, it appears that §59 should override other Code or regulatory provisions which would preclude a current deduction of only a portion of qualified expenditure.

Comment: The fact that a §59(e) election may be made for a portion of a qualified expenditure confers important advantages on the taxpayer. For example, where the taxpayer cannot absorb the full amount of a current deduction, either due to a potential minimum tax liability or some other reason (*e.g.*, expiring net operating loss carryovers), capitalization under the normal Code provisions exacts a penalty: the taxpayer must forego the current deduction and capitalize the entire amount of the expenditure. Section 59(e) offers a superior choice in such a case by permitting the taxpayer to capitalize just the right amount and claim a current deduction for the balance. Also, the §59(e) election may be utilized to defer the right amount of the mining exploration and development expenditures and the IDCs to maximize the percentage depletion deduction by avoiding the impact of the 50% and the 65% taxable income limits of §613(a) and §613A(d)(1) respectively.

(3) Basis Adjustment and Dispositions of Underlying Property

The statute is completely silent as to the basis adjustments required upon the capitalization of qualified expenditures under §59(e). Specifically, when a qualified expenditure is capitalized under §59(e), the question arises: should the basis of the underlying property be increased by the amount of the capitalized expenditure; or does an election under §59(e) create a separate asset with a basis equal to the amount of the capitalized expenditure? A related question involves the tax treatment to be accorded to the unamortized portion of the expenditures capitalized under §59(e) upon a sale, exchange, or other disposition of the underlying property. The answer to this as well as other related questions (*e.g.*, recapture) will, of necessity, depend upon how the basis adjustment question is answered.

Section 1016(a)(23), added to the Code by TRA 1986 provides that a proper adjustment shall be made to the basis of the property for amounts allowed as a deduction under §59(e).[217] It might be inferred from this that, upon making the §59(e) election, the taxpayer is required to add the amount of the capitalized expenditures to the property's basis. After all, if the basis of the property must be reduced for deductions taken under §59(e), it is logical to assume that the property's basis should initially be increased by the amount of the expenditures capitalized under §59(e). Such an inference could be accepted as accurate were it not for the problems caused by §59(e)(3).[218] For example, if the mining development expenditures capitalized under §59(e) are added to the depletable basis of the mining property, the taxpayer would be entitled to recover such expenditures through depletion deductions. Depletion deductions are, however, expressly barred by §59(e)(3) with respect to expenditures capitalized under §59(e). Again, if the mining property in the above example is abandoned as worthless before the capitalized development expenditures have been fully recovered, the taxpayer would be entitled to a loss deduction under §165 with respect to the unamortized portion of the mining development expenditures capitalized under §59(e). A loss deduction under §165 for amounts capitalized under §59(e), however, is similarly barred by §59(e)(3). Finally, §59(e)(3) can also be read to deny a basis adjustment attributable to the unamortized portion of the amounts capitalized under §59(e) for purposes of computing gain (or loss) upon the sale or exchange of the underlying property.[219]

An alternative approach would be to regard a §59(e) election as creating an intangible nontransferable asset separate and apart from the underlying property with a basis equal to the amount of expenditures capitalized under §59(e). The adoption of this approach would eliminate the double deduction problem and the problems encountered at the abandonment or sale of property under the first approach. Where the taxpayer, for example, capitalizes $10,000 in mining exploration costs under §59(e), such capitalization would create an asset separate and apart from the underlying mining property with a basis of $10,000. This asset would be amortized ratably over a 10-year period with the taxpayer getting a $1,000 deduction in each of the 10 years. If the mining property is abandoned before the $10,000 mining exploration costs have been fully amortized, the taxpayer will not face the problem of denial by §59(e)(3) of a loss deduction (under §165) attributable to the unamortized portion because he would simply continue to amortize the unamortized portion until exhausted. Again, if the mining property was sold, the capitalized mining exploration costs would not figure in the computation of gain (or loss) from the property, and any unamortized portion of the costs would continue to be amortized by the taxpayer, thus avoiding the problems posed by §59(e)(3).

This separate asset approach, however, is not without its problems. For example, §59(e)(5) requires a recapture of the IDCs, the mining exploration and the mining development costs when the underlying property is disposed of. In the example above, if the taxpayer disposes of the mining property after three years the question arises: is the taxpayer required to recapture only $3,000 of the mining

[217] The statute mistakenly refers to §59(d). It is expected that this error will be corrected in a forthcoming technical corrections bill.

[218] §59(e)(3) provides that "Except as provided in this subsection, no deduction shall be allowed under any other section for any qualified expenditure to which an election under this subsection applies."

[219] *See* Linden & Meyer, "Changes by TEFRA in Treatment of Oil, Gas and Mining Will Significantly Affect Planning," 57 J. Tax. 355 (1982), which pointed out similar problems created by the predecessor of §59(e), *i.e.*, §58(i).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

exploration costs or must the taxpayer recapture the entire $10,000? If the taxpayer is required to recapture only $3,000, the balance of $7,000 (for which the taxpayer would be taking deductions in future years) would go unrecaptured, a situation which is contrary to the mandate of §59(e)(5). On the other hand, if the entire $10,000 must be recaptured, the taxpayer would be required to recapture deductions which he had not taken, a situation which would require a statutory amendment to be effective. Also, if the taxpayer died before the $10,000 mining exploration costs had been fully amortized, the deductions for the unamortized portion would be lost forever.

A third, and perhaps, the most practical approach would be to clearly and carefully circumscribe, by regulations, the scope of the application of §59(e)(3). As drafted, the sweeping language of that paragraph would seem to deny any deduction for the amounts capitalized under §59(e) under any other Code section, including a deduction at the time of abandonment or sale of the underlying property. This may not have been the legislative intent. The concern behind the enactment of §59(e)(3) may have been to prevent a double deduction for the amounts capitalized under §59(e), *i.e.*, once under §59(e) and again as a depletion, or amortization deduction under other Code provisions (*e.g.*, §§611, 613, etc.) when the capitalized amounts are added to the basis of the underlying property. If this is so, the inference can be drawn that Congress expected the amounts capitalized under §59(e) to be added to the basis of the underlying property. In fact, if the scope of §59(e)(3) is limited so that it does not apply to amounts capitalized under §59(e) upon the sale, exchange, or other disposition of the underlying property, all other pieces of the puzzle (*i.e.*, the initial basis adjustment upon capitalization of qualified expenditures under §59(e), §1016(a)(23) basis adjustment, §59(e)(5) recapture provision, the problem of the unamortized amounts, etc.) fall into place. Under this approach, the amounts capitalized under §59(e) would be added to the basis of the underlying property, but only for purposes of computing gain or loss from a sale, exchange or other disposition of the property. This basis would be adjusted under §1016(a)(23) for all deductions taken under §59(e). If the underlying property were abandoned at a time when the §59(e) amounts had not been fully amortized, the taxpayer would be entitled to a loss deduction under §165 for the unamortized amounts. Similarly, if the underlying property were sold or exchanged, the taxpayer's gain would be reduced by the unamortized portion, and the recapture provisions of §59(e)(5) would apply to the extent the §59(e) amounts had been amortized by the taxpayer. Finally, in the case of a nontaxable transfer of the underlying property (*e.g.*, a §351 exchange), the taxpayer's basis in the property received in exchange (*i.e.*, stock in the transferee corporation in a §351 exchange) would reflect the unamortized portion of the §59(e) amounts, the §59(e) amortization schedule would be extinguished, and the transferee would amortize the inherited §59(e) amounts as part of the inherited basis in the underlying property. To the extent that the taxpayer has amortized §59(e) amounts prior to the transfer, the §59(e)(5) recapture provisions should apply. To effectuate this approach, only two clarifications are needed: (i) that the amounts capitalized under §59(e) are added to the basis of the underlying property, but only for purposes of computing the gain or loss (or the basis of property received in a nontaxable exchange) upon the sale, exchange, or other disposition of the underlying property; and (ii) that §59(e)(3) does not apply when the underlying property is sold, exchanged, or otherwise disposed of.

(4) Time and Manner of Making Election

The statute is silent as to the time and manner of making an election under §59(e). It only states that "an election under this subsection may be revoked only with the consent of the Secretary." [220] In view of this silence, guidance provided by the Service under the predecessor of §59(e), *i.e.*, §58(i), may be relied upon at least until such time as the Service issues revised rules.

Temp. Regs. §5f.0(a)(2)(i)[221] provides that an election under §58(i) may be made no later than the due date of the return for the taxable year (including extensions) for which the election is effective.

Comment: The timing of the election provides a taxpayer with an opportunity to plan for avoiding AMT by capitalizing under §59(e) the right amount of expenditures subject to that subsection and deducting the balance currently.

Temp. Regs. §5f.0(a)(3) provides that an election under §58(i) may be made by attaching a statement to the income tax return for the taxable year for which the election is made. The statement is required to contain the following information:

(i) The name, address, and taxpayer identification number of the electing taxpayer;

(ii) The fact that an election is being made;

(iii) The Code section under which the election is being made;

(iv) The taxable year and the property to which the election applies; and

(v) The information necessary to show that the taxpayer is entitled to make the election.

A partnership makes the §59(e) election separately by each partner with respect to the partner's allocable share of any qualified expenditure. A similar rule applies to S corporations and their shareholders.[222]

(5) Recapture of Amounts Subject to §59(e) Election

Section 1254, as revised by the TRA 1986, provides that, upon the disposition of an interest in a mine, well, or other natural deposit, the taxpayer must recapture as ordinary income the aggregate amount of: (i) expenditures deducted under §263, 616, or 617 with respect to such property which, but for such deduction, would have been included in the adjusted basis of such property; and (ii) the amounts deducted as depletion under §611 which reduced adjusted basis of such property. Of course, the amount of

[220] §59(e)(4)(B).
[221] *See* T.D. 7870 dated January 2, 1983.
[222] §59(e)(4)(C).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

gain recaptured as ordinary income is limited to the amount of gain realized upon the disposition of the property.

Section 59(e)(5)(A) requires that, upon the disposition of any §1254 property, any expenditures allocable to such property which were deducted under §59(e) must be recaptured as ordinary income. Thus, the IDCs and the mining development and exploration costs which are capitalized and amortized pursuant to a §59(e) election must be recaptured as ordinary income when the underlying property is disposed of.

With respect to mining exploration expenditures, §59(e)(5)(B) acts as a back-stop to §59(e)(5)(A). Thus, any mining exploration expenditures capitalized and amortized under §59(e) that are not recaptured as ordinary income under §1254 will be recaptured as ordinary income under §617(d).[223] Section 617(d) provides that, upon the disposition of a mining property, a portion of the mining exploration expenditures deducted currently under §617(a) must be recaptured as ordinary income. The portion required to be recaptured is the lesser of the adjusted mining exploration expenditures or the amount of the gain.

2. Tentative Minimum Tax

The tentative minimum tax in the case of noncorporate taxpayers is computed by multiplying the alternative minimum tax base by 21% and reducing the product by the alternative minimum tax foreign tax credit for the taxable year.[224] The AMT base is obtained by subtracting the exemption amount from AMTI.[225]

a. The Exemption Amount

For taxpayers who file a joint return (or who are surviving spouses[226]) the exemption amount is $40,000.[227] The exemption amount is $30,000 for unmarried individuals who are not surviving spouses.[228] For estates and trusts and married individuals filing separate returns, the exemption amount is $20,000.[229] These exemption amounts, however, are phased out by 25 cents for each $1 once AMTI reaches certain levels.[230] For married individuals filing joint returns and surviving spouses, the phaseout begins when AMTI reaches $150,000.[231] The entire $40,000 exemption amount is phased out when AMTI reaches $310,000. Consequently, for individuals filing joint returns, the AMT base is equal to AMTI, provided AMTI for the taxable year is $310,000 or more.

For unmarried individuals who are not surviving spouses or heads of household, the phaseout of the exemption amount begins when AMTI reaches $112,500.[232] The entire exemption amount of $30,000 is phased out when AMTI for the taxable year reaches $232,500. Thus, for such taxpayers, the AMT base is equal to AMTI if AMTI for the taxable year is $232,500 or more.

For estates, trusts and married individuals filing separate returns, the phase-out begins when AMTI for the taxable year reaches $75,000.[233] The entire exemption amount of $20,000 is phased out when AMTI for the taxable year reaches $155,000. Consequently, for such taxpayers the AMT base equals AMTI provided AMTI for the taxable year is $155,000 or more.

b. Alternative Minimum Tax Foreign Tax Credit

As previously indicated, the only nonrefundable credit allowable against AMT is the foreign tax credit. This result is achieved by reducing the tentative minimum tax (computed by multiplying the AMT base times, 21%) by the AMT foreign tax credit before AMT is compared with regular tax.

(1) General

The United States taxes domestic corporations and individual citizens and resident aliens on their worldwide income. This worldwide taxation may result in double taxation of the foreign income, *i.e.*, once in the country of source and again by the United States. With a view to avoid, or at least mitigate, this potential double taxation of U.S. persons, Congress enacted a dollar-for-dollar credit against U.S. tax for income taxes paid to foreign countries on foreign income. The foreign tax credit provisions are contained in §§901-908 and §960.

Since the basic function of the foreign tax credit is to prevent double taxation of the foreign source income and not to reduce U.S. tax on U.S. source income, §904 provides limits on the foreign tax credit to ensure that the credit is not greater than the U.S. tax attributable to foreign income. The §904 limit is expressed mathematically as follows:

$$\frac{\text{Tentative U.S. Tax} \times \text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}}$$

Any foreign taxes disallowed because of the foreign tax credit limit may be carried back two years and forward five under §904(c).

(2) Computation of AMT Foreign Tax Credit

The AMT foreign tax credit is computed by utilizing the regular tax foreign tax credit rules, with the following modifications:

(i) In the formula for computing the §904 limit, tentative AMT is substituted for tentative U.S. tax[234] and foreign source taxable income and worldwide taxable income are computed by making the adjustments provided in §§56 and 58, as well as by adding back the §57 items of tax preference to taxable income.[235]

[223] *See* §§59(e)(5)(B) and 617(d)(5).
[224] §55(b)(1).
[225] §55(b)(1)(A).
[226] For a definition of "surviving spouse" *see* §2(a).
[227] §55(d)(1)(A).
[228] §55(d)(1)(B).
[229] §55(d)(1)(C).
[230] §55(d)(3).
[231] §55(d)(3)(A).
[232] §55(d)(3)(B).
[233] §55(d)(3)(C).
[234] §59(a)(1)(A).
[235] §59(a)(1)(B).

Comment: The allocation of adjustments and preferences to U.S. or foreign source income may change the ratio of foreign source taxable income to worldwide income for AMT foreign tax credit purposes. The AMT foreign tax credit allowable under §904 may, therefore, be more or less than the foreign tax credit allowable under §904 for regular tax purposes. Taxpayers will, therefore, be required to keep track of credit carryovers separately for regular and AMT purposes.

(ii) The amount of AMT foreign tax credit allowable under §904 for the taxable year is subject to another limit: it may not offset more than 90% of tentative minimum tax computed without regard to the foreign tax credit and the alternative minimum tax net operating loss deduction.[236] For example, assume that in 1987, a taxpayer has $10 million in AMTI (without regard to any AMT net operating loss deduction). The taxpayer's tentative minimum tax liability (computed without regard to the AMT foreign tax credit and the NOL deduction) is therefore $2.1 million. Accordingly, the AMT foreign tax credit may not exceed 10% of $2.1 million or $1,890,000. Stated differently, AMT foreign tax credit may not reduce taxpayer's tentative AMT liability (computed without regard to the foreign tax credit and NOL deduction) below 10% of such tax. Thus, in the example above, AMT foreign tax credit may not reduce taxpayer's tentative minimum tax below 10% of $2.1 million or $210,000. The mechanics of the 90% limitation computation are provided in §59(a)(2)(A). It provides that AMT foreign tax credit is limited to the extent tentative minimum tax computed under §55(b)(1)(A) exceeds 10% of such amount determined without regard to NOL deduction. The amount determined under §55(b)(1)(A) is 20% of the AMT base. The application of §59(a)(2)(A) is illustrated by the following example.

Example: Individual A has $10 million AMTI in 1988 and has a $2 million NOL deduction. It computes the 90% limitation under §59(a)(2)(A) as follows:

(i) Tentative AMT Determined under §55(b)(1)(A)

AMTI = $10 million

NOL Deduction = $2 million

AMT Base = $10 million − $2 million = $8 million

Tentative AMT = 21% of $8 million = $1.68 million

(ii) Tentative AMT Under §55(b)(1)(A) Without Regard to NOL Deduction

AMTI = $10 million

Tenative AMT = 21% of $10 million = $2.1 million

10% of Tentative AMT = $210,000

(iii) Excess of (i) over (ii)

Section 59(a)(2)(A) Limitation = $1,680,000−$210,000 = $1,470,000

Thus A's AMT foreign tax credits will be disallowed to the extent they exceed $1.47 million even though its §904 limitation is greater than $1.47 million. Note also that A will have a tentative AMT of at least ($1.68 million − $1.47 million) $210,000 which is 10% of 2.1 million tentative AMT liability computed under §55(b)(1)(A) without regard to NOL deduction.

Comment: The reason for computing the 90% limitation without regard to the AMT net operating loss deduction is to coordinate this limitation with the 90% limitation on AMTI that may be offset by AMT net operating loss deduction in any given year. The 90% limitation on NOL deduction is applied before the 90% limitation on AMT foreign tax credit. Thus, if alternative tax NOL deduction in any taxable year reduces the §55(b)(1)(A) tentative AMT below 10% of such tax (computed without regard to NOL deduction) no AMT foreign tax credit will be allowed that year against the minimum tax. For example, suppose A has an AMTI of $10 million and an NOL deduction of $11 million in 1987. Since the NOL deduction may offset AMTI only up to (90% of $10 million) $9 million, A's tentative minimum tax computed under §55(b)(1)(A) is 21 percent of $1 million) $210,000. Since under the 90% limitation on AMT foreign tax credits of §59(a)(2)(A) the tentative minimum tax may not be reduced below (10% of $2.1 million tentative tax under §55(b)(1)(A) computed without regard to NOL deduction) $210,000, no AMT foreign tax credit will be allowed A in 1987.

Any AMT foreign tax credit that is disallowed either due to the §904 limitation or the 90% limitation discussed above is available as a carryover in accordance with the rules provided in §904(c).[237] The amount of AMT foreign tax credit allowable in the carryover years, however, will again be subject to the two limitations.

3. Net AMT Liability

After a taxpayer has computed his tentative minimum tax for the taxable year it is compared with taxpayer's "regular tax" for the taxable year. If the tentative minimum tax is greater than the regular tax, the taxpayer pays the tentative minimum tax as his final tax liability for the taxable year. Technically, the tentative minimum tax, if greater than the regular tax, has two components, the regular tax and the net alternative minimum tax, with the excess of tentative minimum tax over the regular tax being referred to as the taxpayer's net alternative minimum tax liability.

As will be discussed *infra*, regular tax is not reduced by any nonrefundable credits (other than the foreign tax credit) prior to comparing it with tentative AMT. If, however, the comparison reveals that the regular tax is greater than the tentative AMT, then nonrefundable credits are applied to reduce regular tax but not below the tentative AMT.[238] Any nonrefundable credits that are not used against regular tax due to the tentative AMT limit, are available as carryovers under the normal Code provisions governing the carryovers of such credits.

a. Regular Tax

"Regular tax" as used in the AMT context is a term of art and is not synonymous with the amount of "regular tax" that a taxpayer may owe for taxable year. For pur-

[236] §59(a)(2)(A).

[237] §59(a)(2)(B).

[238] §55(c)(1) and (2).

poses of AMT, "regular tax" means the regular tax liability for the taxable year (as defined in §26(b)), computed without regard to §§402(e) and 47, and reduced by the foreign tax credit allowable under §27(a).[239] Thus, for purposes of comparison with tentative AMT, regular tax undergoes two types of adjustments:

(i) as specified in §§26(b) and 55(c)(1), certain taxes are disregarded, and

(ii) the only nonrefundable credit allowed against regular tax is the foreign tax credit.

(1) Taxes Disregarded

In computing "regular tax" for AMT purposes, taxes imposed under the following Code sections are disregarded:[240]

(i) §47 (pertaining to increases in tax);

(ii) §53 (relating to minimum tax);

(iii) Subsections (m)(5)(B), o(2), or (q) of §72 (relating to additional tax on certain distributions);

(iv) §402(e) (relating to the tax on lump-sum distributions);

(v) §408(f) (relating to additional tax on income from certain retirement accounts);

(vi) §531 (relating to accumulated earnings tax);

(vii) §541 (relating to personal holding company tax);

(viii) §1351(d)(1) (relating to recoveries of foreign expropriation losses);

(ix) §1374 (relating to tax on certain built-in gains of S corporations);

(x) §1375 (relating to tax imposed when passive investment income of S corporation having subchapter C earnings and profits exceeds 25% of gross receipts);

(xi) §7518(g)(6)(A) (relating to nonqualified withdrawals from capital construction funds taxed at highest marginal rate); and

(xii) §§871(a) and 881 (relating to certain income of nonresident aliens and foreign corporations.)

(2) Non Refundable Credits

Regular tax, computed without regard to the taxes described in the preceding section, is reduced by the foreign tax credit before comparing it with tentative AMT. If tentative AMT is greater than the regular tax, the taxpayer pays the tentative AMT and no nonrefundable credit (other than the foreign tax credit) is allowed against the regular tax. If, however, the regular tax (as reduced by the foreign tax credit) is greater than the tentative AMT, other nonrefundable credits are applied to reduce the regular tax, but not below the tentative AMT. Any nonrefundable credits that are not utilized against the regular tax due to the tentative AMT limit may be available as carryovers under the Code provisions dealing with such credit carryovers.

If the regular tax is greater than the tentative AMT, the nonrefundable credits (including the foreign tax credit) are applied against the regular tax in the following order:

(i) The sum of the dependent care credit (§21), the credit for the elderly (§22), and the mortgage interest credit (§25) is applied to reduce regular tax (before reduction by the foreign tax credit), but not below the tentative AMT (unreduced by the foreign tax credit).[241] If the sum of the credits provided in §§21, 22 and 25 is not fully absorbed by the regular tax for the taxable year due to the tentative AMT limit, not only this balance of these credits (except the §25 credit) lost permanently (because of a lack of carryover provision) but, also, no other nonrefundable credit (other than the foreign tax credit) will be allowed against the regular tax in that year. Any §25 credit disallowed due to the tentative AMT limit may be carried forward for three years.

(ii) Whether or not §§21, 22 and 25 credits were absorbed fully by the regular tax under (i) above, the taxpayer may next reduce both the regular tax and the tentative AMT by the foreign tax credit under §27.

(iii) The clinical testing credit (§28) is allowed to reduce the regular tax, but only to the extent the regular tax (as reduced by §§21, 22, 25 and 27 credits) exceeds the tentative AMT.[242] Any §28 credit disallowed under this provision is lost permanently.

(iv) Next, the credit for producing fuel from a nonconventional source (§29) is applied to reduce the regular tax to the extent the regular tax (as reduced by §§21, 22, 25, 27, 28 credits) exceeds the tentative AMT.[243] Any §29 credit disallowed under this limit is lost permanently.

(v) Next, the general business credit (*i.e.* the sum of the investment credit determined under §46(a), the targeted jobs credit determined under §51(a), the alcohol fuels credit determined under §40(a), the research credit determined under §41(a), and the low income housing credit determined under §42(a)) is applied against the regular tax. The amount of this credit allowable in any taxable year, however, is limited to the lesser of:

(i) the allowable portion of the taxpayer's net regular tax liability, or

(ii) the excess of the taxpayer's net regular tax liability over the tentative AMT.[244]

"Net regular tax liability" means regular tax reduced by the §§21, 22, 25, 27, 28 and 29 credits.[245] The allowable portion of net regular tax liability means $25,000, plus 75% of so much of net regular tax liability for the taxable year which exceeds $25,000.[246] Any general business credit disallowed under the limit discussed above is available as a carryover (*i.e.* three years back and 15 forward).[247]

[239] §55(c)(1).
[240] §§26(b) and 55(c)(1).
[241] §26(a).
[242] §28(d)(2).
[243] §29(b)(5).
[244] §38(c)(1).
[245] §38(c)(2).
[246] *Id.*
[247] §39(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(vi) Finally, the 1986 TRA-enacted minimum tax credit (§53) is applied against the regular tax, but only to the extent the regular tax (as reduced by the §§21, 22, 25, 27, 28. 29 credits and the general business credit) exceeds the tentative AMT for the taxable year.[248] Note that the minimum tax credit is cumulative, *i.e.*, it includes the minimum tax credits disallowed in prior years under the limit discussed above.[249]

C. Collateral Rules

1. Minimum Tax Credit

a. General

The philosophical basis of the add-on minimum tax, which applied to all taxpayers prior to the Tax Equity and Fiscal Responsibility Act of 1982 and to corporate taxpayers only prior to the TRA 1986, was that tax preferences and tax incentives were bad *per se* and therefore, taxpayers using them should pay a tax thereon. The philosophical basis of the alternative minimum tax (which now applies to all taxpayers) on the other hand, is that tax preferences and tax incentives are not evil *per se*, but a taxpayer should not be permitted to use them to reduce his tax liability below a minimum standard. Prior to the 1986 Act, this minimum standard was applied on an annual basis: a taxpayer paid the minimum tax if, in any taxable year, the use of tax preferences or tax incentives reduced the regular tax liability below the minimum standard. The minimum standard was abandoned in other years in which the regular tax was higher than the minimum standard, with no offsetting adjustments or credits for the minimum tax paid in a prior year. This application of the minimum standard on an annual basis often resulted in inequities because, due to the imposition of the AMT, taxpayers did not derive the amount of regular tax benefit from items of tax preference which they would have obtained if those items had not received preferential treatment in the first place. To eliminate this inequity, the drafters of the 1986 Act made two important changes to the AMT structure: they introduced (i) the adjustment mechanism (§§56 and 58), and (ii) the minimum tax credit of §53. It was seen earlier how the adjustment mechanism provides compensating adjustments to AMTI in subsequent years. The minimum tax credit similarly compensates the taxpayer for the loss of regular tax benefit in an AMT year by reducing the regular tax in subsequent years when the taxpayer is not in an AMT position.

b. Operative Rules

When a taxpayer is subject to minimum tax liability in any taxable year, the amount of adjusted net AMT paid in that year is available as a credit against his regular tax liability in future years. This credit, however, will not reduce the regular tax below the tentative AMT in any year. Note that the entire net AMT liability for a taxable year may not be available as a credit. Under §53(b), if a portion of net AMT liability for a taxable year is attributable to the itemized deductions adjustment, the depletion preference, the exempt interest preference, or to the preference for charitable contributions of appreciated property, such portion is not available as a credit.[250] Thus, in an AMT year, a taxpayer must make two distinct AMT computations: one taking into account all the items of adjustment (within the meaning of §§56 and 58) and preferences (within the meaning of §57), and another as if the only item of adjustment was the itemized deductions and the only items of preference were the depletion deduction, the exempt interest exclusion and the deduction for charitable contributions of appreciated property. The amount of net AMT available as a credit is then obtained by subtracting the result of the second computation from the result of the first.

In any taxable year, the amount of minimum tax credit that may be applied to reduce regular tax is limited, like all other nonrefundable credits, to the excess of the regular tax (as reduced by all other nonrefundable credits) over tentative AMT.[251] Thus, the minimum tax credit is available only after all other nonrefundable credits have been utilized and there remains an excess of the regular tax over tentative AMT. The amount of minimum tax credit that is not utilized against regular tax because of the tentative AMT limitation is carried over to the following taxable year, is aggregated, and becomes part of the minimum tax credit for that year.[252] The minimum tax credit may be carried forward indefinitely; however, it may not be carried back.[253]

2. Trusts and Estates

Under the AMT, as revised by the TRA 1986, the items of preferences and adjustments are no longer required to be apportioned between trusts and estates and their beneficiaries. Under §59(c), AMTI of a trust, estate or its beneficiaries is determined by computing the distributable net income (DNI) on an AMT basis to the extent it is not inconsistent with §643(a).[254] Thus, for purposes of AMTI, a trust or an estate will compute its DNI by taking into account the items of adjustments under §56 and 58, and the items of tax preference under §57, except to the extent it is inconsistent with the modifications provided in §643(a). For example, no exemption amount will be allowed in computing DNI for AMTI purposes.

3. Apportionment of Differently Treated Items

In the case of a regulated investment company or a real estate investment trust, items of tax preference and other items (*e.g.* items of adjustment, credits), which are treated differently for regular tax purposes, are required to be apportioned between such company or trust and its shareholders or holders of beneficial interest in accordance with regulations to be prescribed.[255]

In the case of a common trust fund, the differently treated items are required to be apportioned among the participants on a *pro rata* basis.[256]

4. Tax Benefit Rule

The Conference Report states that "Since the regular and minimum taxes generally are computed separately,

[248] §53(c).
[249] §53(b).
[250] §53(d)(1)(B).
[251] §53(c).
[252] §53(b).
[253] *Id.*
[254] Conference Report, p. II-263.
[255] §59(d)(1)(A).
[256] §59(d)(1)(B).

relief from the minimum tax under the tax benefit rule is not appropriate solely by reason of the fact that a taxpayer has received no benefit under the regular tax with respect to a particular item." [257] The statute, nevertheless, leaves it within the secretary's discretion to provide, by regulations, for the adjustment of differently treated items where the tax treatment accorded such items does not result in a reduction of the taxpayer's regular tax for any taxable year.[258]

[257] Conference Report, p. II-262.
[258] §59(g).

5. Short Taxable Year

Section 443(d) provides rules for dealing with short taxable years for AMT purposes. Essentially, §443(d) requires annualization of both the AMTI and the tentative minimum tax to determine the taxpayer's minimum tax liability for a short taxable year. The annualization is accomplished by multiplying the AMTI for the short period by 12 and dividing it by the number of months in the short taxable year. The tentative minimum tax is similarly annualized.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 33

ALTERNATIVE MINIMUM TAX FOR CORPORATE TAXPAYERS

Javed A. Khokhar, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

The Tax Reform Act of 1986 imposed, for the first time in the history of minimum tax, an alternative minimum tax on corporate taxpayers. This tax replaced the add-on minimum tax to which corporate taxpayers were subject before the Act. The revised alternative minimum tax (AMT) imposed on corporations is similar to the AMT imposed on individual taxpayers. The following summary of the history of the minimum tax is intended to help put the 1986 Act changes in perspective.

A. The Tax Reform Act of 1969

The minimum tax stems from tax reform studies first undertaken by the Treasury Department during the Johnson administration. The Treasury proposals [1] evidenced a concern that the tax laws permitted some individuals with very large incomes to pay little or no tax, while other individuals with far less income were required to pay a higher percentage of their income in tax, and persons with low and modest incomes paid a significant share of their income in tax. It was felt that this undermining of the progressive rate structure and unfair allocation of the tax burden was caused by the existence of a favored tax status afforded certain types of income.

The Treasury proposals isolated four tax preferences that it felt contributed most significantly to this disparity in treatment among individuals (corporations were not subject to these proposals). These were the §1202 net long-term capital gains exclusion (with the alternative of taxing the entire gain at a 25% rate), tax-exempt interest received on state and local government bonds, the exclusion resulting from percentage depletion in excess of the capital invested in the ownership of minerals or other natural resources, and the appreciation element in charitable gifts of appreciated property to the extent deductible under §170.

Treasury proposed a graduated minimum tax rate (7-35%) to be applied to an expanded income base. The income base was to consist of taxable income plus the above mentioned preferences. If this tax was higher than the tax computed under the normal rates, it became the taxpayer's final tax liability.

In computing the minimum tax base, the individual was to be allowed all his itemized deductions or a special $10,000 standard deduction if more advantageous. The proposals did not stop there, however. They also introduced a concept called "allocation of deductions." This approach required an individual to allocate his non-business expense deductions between taxable and exempt income, and allowed such deductions only to the extent allocable to taxable income. This concept generally was aimed at preventing use of preference-related deductions against otherwise taxable income.

The Treasury studies recommended that certain individual non-business itemized deductions [2] (that is, most itemized deductions) be allocated between income and preference income, with only the part allocable to taxable income being permitted as deductions in computing tax. Here, as in the minimum tax computation, relief was provided for taxpayers with minor amounts of preferences: an individual with $5,000 or less of preferences was not subject to the allocation.

The Treasury studies served as the basis for the subsequent submission of proposals to Congress by the Nixon Administration and the ultimate enactment of an add-on [3] minimum tax by the Tax Reform Act of 1969 (P.L. 91-172).

The 1969 TRA added Code §§56, 57, and 58.[4] Under these provisions, effective for taxable years ending after 1969, both individuals and corporations were subjected to a minimum tax which applied in addition to the regular tax. The minimum tax was calculated by applying a 10% rate to the taxpayer's minimum tax base. The minimum tax base was computed by adding to the regular tax base certain tax preferences and subtracting the regular federal income taxes paid by the taxpayer and an exemption amount of $30,000. Spouses who filed separate returns, where each spouse had tax preferences, were required to split the $30,000 exemption amount.

The tax preference items included in the minimum tax base by the 1969 TRA were:

(1) Excess investment interest. This was the excess of investment interest expense over net investment income.

[1] Treasury Tax Reform Studies and Proposals (Part 2) pp. 132 and 142 (1969).

[2] The nonbusiness deductions to be so allocated were interest, taxes, casualty losses, charitable contributions, medical expenses, and cooperative housing expenses.

[3] An add-on minimum tax is a tax which applies in addition to taxpayer's regular tax liability.

[4] Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The preference applied only to individuals, subchapter S corporations, and personal holding companies, and then only until 1972.

(2) Accelerated depreciation on personal property subject to a net lease.

(3) Accelerated depreciation on real property.

(4) Amortization of rehabilitation expenditures.

(5) Amortization of certified pollution control facilities.

(6) Amortization of railroad rolling stock.

(7) The bargain element in certain tax-favored stock options.

(8) Bad debt deductions of financial institutions. This basically was a corporate preference item.

(9) The excess of depletion deductions taken for the year over the cost of the property reduced for depletion taken in prior years.

(10) Capital gains. For corporations, this was the excess of net long-term capital gain over net short-term capital loss multiplied by a ratio, the denominator of which was the regular corporate tax rate (*i.e.*, 48%) and the numerator of which was the regular corporate rate minus the capital gains rate applicable to corporations.[5]

Because the minimum tax was not achieving its purpose, considerable pressure was put on Congress to tighten it to insure that the original objective was achieved. A considerable tightening of the minimum tax rules took place in the Tax Reform Act of 1976.

B. The Tax Reform Act of 1976

The Tax Reform Act of 1976 (P.L. 94-455) strengthened the minimum tax by increasing the effective tax rate and adding some preference items.

The minimum tax rate was increased from 10% to 15%. For corporate taxpayers the exemption amount was reduced to the greater of: (i) $10,000, or (ii) the full amount of regular tax.[6]

Although a number of items of tax preference were added to the minimum tax base for noncorporate taxpayers, the minimum tax base for corporations remained unchanged. The items of tax preference for noncorporate taxpayers added by the 1976 TRA included:

(1) Excess itemized deductions. This was the taxpayer's itemized deductions (other than deductions for medical expenses and casualty losses) in excess of 60% of adjusted gross income (reduced by the deductions for medical expenses and casualty losses).

(2) Intangible drilling costs. The excess of deductible intangible drilling costs paid or incurred in connection with productive oil and gas wells over the amount that would have been deductible if such costs had been capitalized and either amortized over a 10-year period or deducted over the lives of the wells as cost depletion.

(3) Accelerated depreciation on personal property. The tax preference item for accelerated depreciation on personal property subject to a net lease was expanded to cover all leased personal property.

The 1976 TRA changes were generally effective for taxable years beginning after 1975.

C. Revenue Act of 1978

The Revenue Act of 1978 (P.L. 95-600) restructured the minimum tax provisions applicable to noncorporate taxpayers for taxable years beginning after 1978. The add-on minimum tax, as in effect in 1978, no longer applied to the capital gains and the excess itemized deductions preference items. These two items instead formed part of a revised alternative minimum tax which took effect in taxable years beginning after 1978. Thus, for 1979 and later years, noncorporate taxpayers were subject to two distinct types of minimum tax: under §56, they were liable for an add-on minimum tax, and under §55 they were liable for an alternative minimum tax.[7]

D. History of the Alternative Minimum Tax (AMT)

1. AMT Under the Revenue Act of 1978

The Revenue Act of 1978 added Code §55. Section 55 imposed an alternative minimum tax on noncorporate[8] taxpayers' "alternative minimum taxable income" to the extent it produced a higher tax than the taxpayers' regular tax liability (as increased by the §56 add-on minimum tax). "Alternative minimum taxable income" was determined by adding back to the taxpayer's taxable income the preference items for the adjusted itemized deductions and the capital gains deduction for the taxable year.[9]

Note: In computing "alternative minimum taxable income," amounts otherwise included in income pursuant to §86 (as a result of the income tax credit for alcohol fuels allowable in the prior taxable year) or §667 (as a result of any accumulation distributions from a trust) were excluded.[10]

An individual taxpayer's preference for adjusted itemized deductions was equal to the taxpayer's itemized deductions (other than the deductions for medical expenses, casualty losses, state, local or foreign taxes, and estate taxes) in excess of 60% of adjusted gross income (reduced by the deductions for medical expenses, casualty losses, state, local, or foreign taxes, and estate taxes).[11] For estates and trusts, however, certain additional adjustments were

[5] In the case of noncorporate taxpayers, this preference was equal to one-half of net long-term capital gain to the extent it exceeded net short-term capital loss.

[6] For noncorporate taxpayers, the exemption amount was reduced from $30,000 plus regular income taxes to the greater of: (i) $10,000, or (ii) one-half of the regular income tax for the year.

[7] For a summary of the add-on minimum tax applicable to noncorporate taxpayers under the 1978 Act, *see* chapter 32, *supra*.

[8] The alternative minimum tax enacted by the Tax Reform Act of 1978 did not apply to corporate taxpayers.

[9] Both the adjusted itemized deductions and the capital gains deduction preferences were excluded from treatment as items of tax preference for purposes of the §56 add-on minimum tax as applied to noncorporate taxpayers.

[10] *See* §55(b)(1), as in effect before TEFRA (P.L. 97-248).

[11] *See* pre-TEFRA §57(b)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

necessary to arrive at the preference amount for adjusted itemized deductions.[12] For individuals who did not itemize deductions, the zero bracket amount was treated as the deduction allowed.[13]

The alternative minimum tax was imposed according to the following rate table:

Alternative Minimum Taxable Income	*Total Tax*
Under $20,000	0
$20,000—$60,000	10%
$60,000—$100,000	$4,000 plus 20% of the excess over $60,000
Over $100,000	$12,000 plus 25% of the excess over $100,000

For taxable years beginning after 1981, the Economic Recovery Tax Act of 1981 (P.L. 97-34) reduced the top alternative minimum tax rate to 20% on all alternative minimum taxable income exceeding $60,000.

For all practical purposes, the amount calculated under the above rate schedule represented the taxpayer's total tax liability (provided it exceeded the "regular tax" for the taxable year). Technically, however, the alternative minimum tax was equal to the gross alternative minimum tax calculated under the above schedule, minus the "regular tax" for the taxable year.

The term "regular tax" encompassed all taxes imposed by Chapter 1 (including §56 add-on minimum tax) for the taxable year other than: (i) the §72(m)(5)(B) penalty tax on premature distributions from HR-10 plans; (ii) the §402(e) tax on lump-sum distributions from tax-qualified retirement plans; (iii) the §408(f) tax on premature distributions from individual retirement accounts; (iv) the §409(c) tax on early redemption of retirement bonds; and (v) the §667(b) tax on accumulated distributions from trusts — reduced by the sum of nonrefundable credits.[14]

Certain nonrefundable credits (other than the foreign tax credit) were allowable against the alternative minimum tax, but only to the extent such tax was not attributable to the net capital gain or the adjusted itemized deductions.[15] In addition, the investment tax credit, the WIN credit, and the targeted jobs credit were allowable against the alternative minimum tax only to the extent such credits were attributable to an active trade or business.[16] Any disallowed credits, however, increased the amount allowed as a carry-over. The foreign tax credit was allowed in full against the alternative minimum tax. In general, the foreign tax credit was computed under the regular foreign tax credit rules of §§901-908. The foreign tax credit limitation of §904(a), however, was computed separately for purposes of the alternative minimum tax. Consequently, the amount of foreign tax credit allowed against the alternative minimum tax was limited to the same proportion of the gross alternative minimum tax as the taxpayer's alternative minimum taxable income from foreign sources bore to his entire minimum taxable income from worldwide sources.[17]

2. *AMT Under TEFRA*

Expressing its dissatisfaction with the way wealthy individuals continued to avoid paying any taxes through the use of exclusions, deductions, and credits, the Congress, in enacting TEFRA (P.L. 97-248), once again revised the minimum tax rules applicable to noncorporate taxpayers.

Effective for taxable years beginning after 1982, TEFRA repealed the §56 add-on minimum tax (as it applied to noncorporate taxpayers) and the §55 alternative minimum tax (as in effect prior to TEFRA) and instead enacted a revised and expanded alternative minimum tax for noncorporate taxpayers.[18]

The Senate Finance Committee Report on H.R. 4961 noted:[19]

> "The Committee has amended the present minimum tax provisions applying to individuals with one overriding objective: no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions and credits. Although these provisions provide incentives for worthy goals, they become counter-productive when individuals are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. Therefore, the Committee has provided an alternative minimum tax which is intended to insure that, when an individual's ability to pay taxes is measured by a broad-based concept of income, a measure which can be reduced by only a few of the incentive provisions, tax liability is at least a minimum percentage of that broad measure. The only deductions allowed, other than costs of producing income, are for important personal or unavoidable expenditures (housing interest, medical expenses and casualty losses) or for charitable contributions, the deduction of which already is limited to a percentage of adjusted gross income.
>
> The Committee's changes in the minimum tax also simplify the taxpayer's computations, since the present law add-on minimum tax is repealed. This change actually provides tax reductions for many middle-income taxpayers who pay a minimum tax on some preference income but also have substantial amounts of non-preference income. By adding all preferences into the base of the alternative minimum tax and focusing the minimum tax on high income individuals, the Committee's provision increases tax liability only for income classes of taxpayers with over $100,000 of income."

[12] *See* pre-TEFRA §57(b)(2).
[13] *See* pre-TEFRA §55(b)(3).
[14] *See* pre-TEFRA §55(b)(2).
[15] *See* pre-TEFRA §55(c)(1). For taxable years beginning prior to 1980, §55(c)(1) did not allow nonrefundable credits (other than the foreign tax credit) to offset the alternative minimum tax. *See* §55(c) prior to amendment by P.L. 96-603.
[16] *See* pre-TEFRA section 55(c)(3).
[17] *See* pre-TEFRA section 55(c)(2)(B).
[18] TEFRA §201.
[19] S. Rep. No. 494, Vol. 1, 97th Cong. 2d sess. pp. 108-109 (1982).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

3. AMT Under the Tax Reform Act of 1984

The Tax Reform Act of 1984 (P.L. 98-369) made certain technical, certain not-so-technical, and certain clarifying amendments to §§55 and 57. In addition, the amendments made by the Act elsewhere (*e.g.*, renumbering and simplification of tax credits, extension of the ACRS recovery period for real estate, etc.) necessitated conforming amendments to the rules governing the computation of the alternative minimum tax.

4. Alternative Minimum Tax Before the Tax Reform Act of 1986 [20]

For taxable years beginning before 1987, §55 imposed on individuals, estates, and trusts, an alternative minimum tax equal to the excess of the gross alternative minimum tax (or "tentative alternative minimum tax") over the regular tax for the taxable year. Before comparing the gross (or tentative) alternative minimum tax, certain adjustments were made to the "regular tax" computed under the normal Code rules: (i) taxes imposed by §§72(m)(5)(B), 72(q), 402(e), 408(f), 409(c), and 667(b) were disregarded; and (ii) the "regular tax" was reduced by credits allowable under Subparts A, B, and D of Part IV of subchapter A.

The gross alternative minimum tax was determined by applying a flat 20% rate to the taxpayer's "alternative minimum taxable income," less the exemption amount specified in §55(f)(1).

Conceptually, the determination of "alternative minimum taxable income" was a two-step process: alternative minimum tax adjusted gross income was computed by using regular tax adjusted gross income as the starting point. Alternative minimum tax adjusted gross income was then reduced by certain specified itemized deductions to arrive at alternative minimum taxable income.

Alternative minimum tax adjusted gross income was obtained by making the following adjustments to regular tax adjusted gross income:

(1) Any amount included in gross income under §87 was excluded;

(2) Any amount included in gross income under §667 was excluded;

(3) The regular tax net operating loss deduction was replaced by the alternative minimum tax net operating loss deduction as defined in §55(d); and

(4) The sum of the items of tax preference deductible in arriving at adjusted gross income was added back.

The items of tax preference required to be added back were set forth in §57(a) and included the following:

(1) The Exclusion for Dividends. Dividends received by individuals from certain domestic corporations and excluded from gross income under §116 of the Code.

(2) ACRS Deductions. For recovery property subject to a lease (other than 19-year real property and low income housing), the excess of the ACRS deduction over the amount that would have been allowed as a deduction had the property been depreciated using a specified longer recovery period under the straight-line method. For 19-year real property, the amount of tax preference was the excess of the ACRS deduction over the amount that would have been allowed had the property been depreciated under the straight-line method.

(3) Accelerated Depreciation. For real property and leased personal property, which was placed in service before 1981 or which was excluded from the application of ACRS, the excess of any allowance for exhaustion, wear and tear, obsolescence, or amortization over the amount that would have been allowable had the taxpayer used the straight-line method for each year of the property's useful life.

(4) Amortization of Pollution Control Facilities. The excess of amortization deductions allowable for the year under the 60-month write-off election of §169 for "certified pollution control facilities" over the amount that would otherwise have been allowable as a depreciation deduction under §167.

(5) Mining Exploration and Development Costs. The excess of the deduction claimed for mining exploration and development costs under §616(a) or §617 over the amount that would have been deductible had such costs been capitalized and amortized over a 10-year period.

(6) Circulation and Research and Development Costs. The preference amount for circulation expenditures was equal to the excess of the allowable deduction under §173 for the taxable year over the amount that would have been allowable had the expenditures been capitalized and amortized over a three-year period. Similarly, the amount of tax preference for research and development costs was the excess of the allowable deduction under §174 for the taxable year over the amount that would have been allowable had the costs been capitalized and amortized over a 10-year period.

(7) Depletion. The excess of the depletion deduction allowable over the property's adjusted basis at the end of the year, disregarding the current year's depletion.

(8) Capital Gains. For individual taxpayers, the net capital gain deduction as determined under former §1202.

(9) Incentive Stock Options. The tax preference for incentive stock options was the excess of the fair market value of a share of stock transferred to the taxpayer at the time of option exercise over the option price .

Once AMT adjusted gross income had been obtained, alternative minimum taxable income (AMTI) was computed by deducting the alternative tax itemized deductions from AMT adjusted gross income. The alternative tax itemized deductions included: (i) casualty and wagering losses under §§165(c)(3) and 165(d); (ii) medical expenses under §213 (as modified by §55(e)(7); (iii) charitable contributions under §170; (iv) qualified interest as defined in §55(e)(3); and (v) estate taxes under §691(c).

Alternative minimum taxable income was then reduced by the exemption amount to arrive at the minimum tax base. The exemption amount was: (i) $40,000 for a joint

[20] All references in this section are to Code sections as they existed before the enactment of the Tax Reform Act of 1986.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

return, (ii) $30,000 for a single return, and (iii) $20,000 for a married individual filing a separate return.

The gross (or "tentative") alternative minimum tax was computed by applying a flat 20% rate to the alternative minimum tax base. Gross alternative minimum tax was then reduced by refundable credits and the foreign tax credit. No nonrefundable tax credits, other than the foreign tax credit, were allowed against the minimum tax. The gross alternative minimum tax (net of credits) was then compared to the regular tax (net of credits). The taxpayer was required to pay the minimum tax if it exceeded the regular tax. Since nonrefundable credits were not allowed against the minimum tax, the taxpayer was allowed a credit carry-over to the extent the taxpayer did not derive a tax benefit from such credits due to the imposition of the minimum tax.

E. Corporate Add-On Minimum Tax Prior to the TRA 1986

Prior to the Tax Reform Act of 1986, corporations were subject to an add-on minimum tax. In addition to the regular tax, §56 [21] imposed on corporate taxpayers a minimum tax equal to 15% of the corporate minimum tax base.

1. Corporate Minimum Tax Base

The corporate minimum tax base was equal to the sum of corporate tax preferences less $10,000 or the regular corporate tax (as determined under §56(c)) whichever was greater.

a. Corporate Tax Preferences

For C corporations the items of tax preference included: (1) accelerated depreciation of real property, (2) amortization of pollution control facilities, (3) bad debt reserves for financial institutions, (4) depletion, and (5) capital gains.

The amount of all the items of tax preference referred to above (except accelerated depreciation of real property), as determined under §57(a), was modified by §57(b).

The §57(b) modification was necessitated by §291, which mandated a 15-20% cutback in certain corporate preferences. Section 291, when first enacted by the TEFRA, provided for a 15% reduction in certain corporate preferences, including the amount not subject to ordinary income recapture upon the sale of §1250 property, the depletion deduction for iron ore and coal, the bad debt reserve deduction, and the amortization deduction for pollution control facilities. The modification of these preferences was effective for taxable years ending after 1982, except for the depletion deduction, which was effective for taxable years beginning after 1983. To avoid the double tax impact of the cutback, TEFRA amended §57(b) to provide for a corresponding reduction in the amount of the affected tax preferences that entered the corporate minimum tax base. The Tax Reform Act of 1984 amended §291 to increase the cutback of certain corporate preferences from 15% to 20%. The affected items included the amount not subject to ordinary income recapture upon the sale of §1250 property, the bad debt reserve deduction, and amortization of certified pollution control facilities. Again, corresponding amendments to §57(b) were made to reflect the increase in the §291 cutback. The amendments made by the 1984 TRA applied generally to taxable years beginning after 1984.

(1) Accelerated Depreciation on Real Property

(a) ACRS Deductions

In the case of 19-year real property, the preference amount was the ACRS deduction for the taxable year, less the amount that would have been allowable as a deduction for the taxable year had the property been depreciated using a straight-line method over 19 years. For low-income housing, the preference amount was the ACRS deduction for the taxable year, less the amount that would have been allowable as a deduction for the taxable year had the property been depreciated using a straight-line method over 15 years. §57(a)(12)(B).

Note: Prior to the passage of P.L. 99-121, the ACRS recovery period for real property was 18 years. In general, however, for property placed in service after May 8, 1985, P.L. 99-121 increased the recovery period to 19 years.

(b) Non-ACRS Depreciation Deductions

Accelerated depreciation on real property not governed by §168 continued to be a tax preference item. Section 57(a)(2) provided that the amount of tax preference for each item of §1250 property was the amount of the deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization, less the amount which would have been allowed had the taxpayer depreciated the property using the straight-line method for each year of its useful life (determined without regard to §167(k)).

(2) Amortization of Certified Pollution Control Facilities

Under §57(b)(1)(A), the corporate minimum tax base included 59-5/6% of the amount computed under §57(a)(4). Under §57(a)(4), the excess of amortization allowable for the taxable year under the 60-month write-off election of §169 for certified pollution control facilities over what would otherwise be allowable as a depreciation deduction under §167 was treated as an item of tax preference.

(3) Bad Debt Reserve Deduction for Financial Institutions

The corporate minimum tax base included 59-5/6% of the amount computed under §57(a)(7).[22] Section 57(a)(7) provided that, in the case of a financial institution to which §585 or §593 applied, this preference was the amount by which the allowable deduction for an addition to its bad debt reserve exceeded the amount that would have been allowable had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience.

The amount which would have been allowable had the institution maintained its bad debt reserve on the basis of actual experience was the amount determined under §585(b)(3)(A) and the regulations thereunder.[23]

[21] All references in this section are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

[22] §57(b)(1)(A).

[23] Regs. §1.57-1(g)(14).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(4) Depletion Deduction

The corporate minimum tax base included the amount computed under §57(a)(8). The amount, however, was reduced to 71.6% of the amount computed under §57(a)(8) in the case of depletion for iron ore and coal.[24] Under §57(a)(8), the excess of the depletion deduction allowable over the property's adjusted basis at the end of the year, disregarding the current year depletion deduction, was an item of tax preference subject to the minimum tax. The excess was computed on each separate "property" as defined for depletion purposes under §614. Accordingly, basis in one property did not reduce excess depletion in connection with another property.

(5) Capital Gains

A corporation which had a net capital gain in a particular taxable year could choose to compute its tax liability under the alternative tax provisions of §1201, provided §1201 produced a tax liability lower than the tax rates of §11(b). The alternative tax was the sum of: (i) tax computed on the ordinary income portion of the taxpayer's income for the taxable year at regular tax rates of §11(b), and (ii) tax computed on the net capital gain for the taxable year at a flat 28% rate.

If a corporation computed its tax liability for a taxable year under §1201, its capital gain preference was computed under §57(a)(9)(B) by multiplying the net capital gain by a fraction. The numerator of this fraction was the differential between the top tax rate specified in §11(b) and 28% (the rate specified in §1201(a)). The denominator was the top corporate tax rate. In view of the cutback in the amount treated as capital gain upon the sale of §1250 property under §291, however, only 59-5/6% of the gain derived upon the sale of §1250 property was taken into account for purposes of determining the capital gain preference under §57(a)(9)(B).

For a corporation to which §1201 did not apply, the capital gain preference was to be computed in accordance with the regulations.[25] Such regulations, were never issued.

b. Additional Preferences for Personal Holding Companies

In addition to the preferences described in the preceding section, a personal holding company also included the following items of tax preference in its minimum tax base:

(1) accelerated depreciation on leased personal (or recovery) property,

(2) mining exploration and development costs,

(3) circulation and research and experimental expenditures, and

(4) intangible drilling costs.

(1) Accelerated Depreciation on Leased Personal Property

(a) ACRS Deductions

For leased recovery property (other than 19-year real property and low income housing), the excess of the ACRS deduction over the amount that would have been allowed as a deduction had the property been depreciated using a specified longer recovery period under the straight-line method constituted an item of tax preference. The longer recovery periods were 5 years, 8 years, 15 years and 22 years for 3-year property, 5-year property, 10-year property and 15-year public utility property respectively.[26] The preference amount was computed separately for each property.

(b) Nonrecovery Property

For leased nonrecovery property the amount by which the depreciation or amortization deduction taken on each §1245 property exceeded the amount that would have been allowed as a deduction if taxpayer had depreciated the property using the straight-line method over the useful life of the property was an item of tax preference.[27]

(2) Mining Exploration and Development Costs

The excess of the deduction claimed for mining exploration and development costs under §617(a) and §616(a), respectively over the amount that would have been allowed as a deduction had such costs been capitalized and amortized ratably over a 10-year period was an item of tax preference.[28]

(3) Circulation and Research and Experimental Expenditures

The preference amount for circulation expenditures was the excess of the allowable deduction under §173 for the taxable year over the amount that would have been allowable had the expenditures been capitalized and amortized ratably over a three-year period.[29] The amount of preference for research and experimental expenditures was the excess of the allowable deduction under §174(a) for the taxable year over the amount that would have been allowable as a deduction had the expenditures been capitalized and amortized over a 10-year period.[30]

(4) Intangible Drilling and Development Costs

The amount of excess intangible drilling and development costs for the taxable year over the taxpayer's net income from oil, gas, and geothermal properties for that taxable year was an item of tax preference.[31] Excess intangible drilling and development costs were the excess of such costs paid or incurred with respect to productive oil, gas, or geothermal wells that the taxpayer elected to deduct under §263(c) over the amount that would have been allowable for the taxable year if the costs had been capitalized and amortized in accordance with any method provided in §57(d). Section 57(d) prescribed either a 120-month amortization or any method permitted for determining cost depletion.

[24] §57(b)(1)(B).
[25] §57(a)(9)(B).
[26] §57(a)(12)(A).
[27] §57(a)(3).
[28] §57(a)(4).
[29] Prior to the Tax Reform Act of 1984, circulation expenditures had to be amortized over a 10-year period to measure the preference amount.
[30] §57(a)(5).
[31] §57(a)(11).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(c) Regular Tax Deduction

For purposes of computing the corporate minimum tax base, §56(c) provided that the regular tax deduction was equal to the corporate tax determined under chapter 1 of the Code without regard to the accumulated earnings tax, the personal holding company tax and the add-on minimum tax and reduced by all the allowable nonrefundable credits.

2. Computation of Minimum Tax

The corporate minimum tax was computed by multiplying the corporate minimum tax base by 15/100. The corporate minimum tax base was obtained by reducing the sum of the items of tax preference by the regular tax deduction for the taxable year. A flat amount of $10,000 was substituted for the regular tax deduction if the amount of that deduction was less than $10,000.

In the case of a controlled group of corporations, the $10,000 deduction was apportioned among the group members in proportion to their regular tax deductions for the taxable year.

3. Rules Pertaining to Foreign Source Deductions

Tax preference items from foreign sources were included in the minimum tax base only if they resulted in foreign losses that reduced the tax imposed on U.S. source income. Capital gains from foreign sources were treated as an item of tax preference only if the jurisdiction of source gave them a preferential treatment.[32]

4. Tax Benefit Rule

Section 58(h) provided for an adjustment of items of tax preference to the extent that the preferential tax treatment accorded such items did not result in a regular tax benefit to the taxpayer.

F. The Tax Reform Act of 1986

Spurred by a concern that the minimum tax was not serving its purpose of preventing taxpayers with substantial economic income from avoiding all tax liability, the 99th Congress restructured and expanded the alternative minimum tax applicable to noncorporate taxpayers, repealed the add-on minimum tax applicable to corporate taxpayers, and enacted an alternative minimum tax for corporate taxpayers similar in structure and substance to that applicable to noncorporate taxpayers. The reasons for replacing the add-on minimum tax with a revised alternative minimum tax for corporate taxpayers (as well as revamping the AMT rules for noncorporate taxpayers) was explained by the Senate Finance Committee Report:

> "The Committee believes that the minimum tax should service one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals and highly profitable corporations to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. In addition, even aside from public perceptions, the Committee believes that it is inherently unfair for high-income individuals and highly profitable corporations to pay little or no tax due to their ability to utilize various tax preferences.
>
> "In particular, both the perception and the reality of fairness have been harmed by instances in which major companies have paid no taxes in years when they reported substantial earnings, and may even have paid substantial dividends to shareholders. Even to the extent that these instances reflect deferral, rather than permanent avoidance, of corporate tax liability, the Committee believes that they demonstrate a need for change.
>
> "The Committee believes that the minimum taxes under present law do not adequately address the problem of tax avoidance, principally for two reasons. First, the corporate minimum tax, as an add-on rather than an alternative tax, is not presently designed to define a comprehensive income base. Second, the present minimum taxes on both individuals and corporations do not sufficiently approach the measurement of economic income. By leaving out many important tax preferences, or defining preferences overly narrowly, the individual and corporate minimum taxes permit some taxpayers with substantial economic incomes to report little or no minimum taxable income and thus to avoid all tax liability.
>
> "With respect to certain items that constitute tax preferences, at least for some taxpayers, under present law, the Committee believes that modifications of the definitions of the preferences are needed. In particular in the case of accelerated depreciation on real and personal property, the Committee believes that the present law fails to account for the fact that the useful lives of items of real and personal property generally are longer than the useful lives applying for minimum tax purposes.
>
> "Moreover, the Committee believes that certain items, not presently treated as preferences, must be added to the minimum tax base if the minimum tax is to serve its intended purpose of requiring taxpayers with substantial economic incomes to pay some tax. The items as to which the Committee has reached this determination include use of the completed contract method of accounting, use of the installment method by dealers, and use of capital construction funds by shipping companies.
>
> "With respect to corporations, the Committee believes that the goal of applying the minimum tax to all companies with substantial economic incomes cannot be accomplished solely by compiling a list of specific items to be treated as preferences. The minimum tax cannot successfully address concerns of both real and apparent fairness unless there is certainty that whenever a company publicly reports substantial earnings (either pursuant to public reporting requirements, or through voluntary disclosure for substantial non-tax reasons), that company will pay some tax (unless it has

[32] §58(g).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

sufficient net operating losses to offset its income for the year).

"Thus, the Committee believes that it is important to provide that the alternative minimum taxable income of a corporation will be increased when book income for the year exceeds alternative minimum taxable income. Such a provision will increase both the real and the perceived fairness of the tax system, eliminate the highly publicized instances in which corporations with substantial book income have paid no tax, and further broaden the minimum tax base to approach economic income more closely."[33]

II. Overview

Section 701 of the Tax Reform Act of 1986 substantially amended §§55, 56, 57 and 58, and added Code §§53 and 59. The alternative minimum tax rules for corporations (and noncorporate taxpayers), after the 1986 TRA, are therefore contained in §§53, 55, 56, 57, 58 and 59.

For taxable years beginning after 1986, amended §55 imposes on corporate taxpayers an alternative minimum tax equal to the excess of the "tentative minimum tax" for the taxable year over the "regular tax" for the taxable year. For §55 purposes, "regular tax" continues to have a special meaning. For corporations, it means the regular tax liability for the taxable year (as defined in §26(b)) computed without regard to any increase in tax under §47, and reduced by the foreign tax credit allowable under §27(a). The tentative minimum tax is equal to 20% of the alternative minimum tax base, reduced by the alternative minimum tax foreign tax credit. The alternative minimum tax base is computed by reducing the alternative minimum taxable income by the exemption amount.

Section 55(b)(2) defines alternative minimum taxable income as the taxable income of the taxpayer for the taxable year adjusted in accordance with §§56 and 58 and increased by the amount of the items of tax preference provided in §57.

This definition of Alternative Minimum Taxable Income (AMTI) has two clear implications:

First, computation of AMTI is a computation entirely distinct and apart from the computation of taxable income for regular tax purposes.

Second, AMTI is computed in the same way as taxable income for regular tax purposes, but with two types of modifications:

(i) certain items of income and deductions used in the computation of regular taxable income are adjusted as provided in §§56 and 58; and

(ii) certain items of tax preference, as provided in §57, are added back to the taxable income (as adjusted under (i) above).

The adjustments required in the computation of AMTI are summarized below.

(a) Depreciation Deductions. For property placed in service after 1986, depreciation deductions are required to be calculated under the Alternative Depreciation System of §168(g), but using the 150% declining balance method switching to straight-line in later years.

(b) Mining Development and Exploration Costs. With respect to each mine or other natural deposit, mining development and exploration costs incurred after 1986 must be capitalized and amortized ratably over a 10-year period.

(c) Long-Term Contracts. For any long-term contract entered into by the taxpayer on or after March 1, 1986, the taxable income from such contract must be determined under the percentage-of-completion method as modified by §460(b).

(d) Net Operating Loss Deduction. In computing the AMTI, the alternative tax net operating loss deduction must be substituted for regular tax net operating loss deduction.

(e) Installment Sales. The installment sales method of accounting is not permitted for the alternative minimum tax purposes. Thus, the taxpayer must include in AMTI the entire gain derived from the sale or other disposition of property under the installment method.

(f) Pollution Control Facilities. For certified pollution control facilities placed in service after 1986, the allowable deduction must be computed under the alternative system of §168(g).

(g) Circulation Expenditures. Circulation expenditures (deductible under §173) incurred after 1986 by personal holding companies must be capitalized and amortized over a three-year period. This adjustment does not apply to corporations other than personal holding companies.

(h) Gain (or Loss) From the Sale or Exchange of Property. In determining gain (or loss), for AMTI purposes, from the sale or exchange of property with respect to which adjustments have been made as described in paragraphs (a), (b), (f), and (g) above, the adjusted basis of such property will be determined based on the treatment prescribed in those paragraphs.

(i) Passive Losses. In computing AMTI, no deduction for losses from certain passive activities is allowed. Passive activity losses for AMTI purposes are computed in the same way as for regular tax purposes, except that the adjustments described in §56 are taken into account and any deduction which is an item of tax preference under §57 is not taken into account. Also, for AMTI purposes, the phase-in rules of §469(l) do not apply.

(j) Capital Construction Funds. Amounts deposited in a capital construction fund (established under §607 of the Merchant Marine Act of 1936) after 1986 are not deductible. Similarly, earnings of such a fund after 1986 are not excludable from gross income. In light of these adjustments, certain adjustments required by the Merchant Marine Act of 1936 (*e.g.*, basis adjustment for amounts withdrawn from the fund) will also not apply in computing the AMTI.

[33] Sen. Rep. No. 313, 99th Cong., 2d Sess., 518-520 (1986) ("Senate Report").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(k) Special Deduction for Certain Insurance Providers. The special deduction allowed for certain existing Blue Cross/Blue Shield organizations and for new organizations meeting certain requirements with respect to high risk coverages under §833(b) of the Code is not allowable in computing AMTI.

(l) Book Income or Earnings and Profits. A corporate taxpayer is required to adjust its taxable income for business untaxed reported profits. For taxable years beginning in 1987, 1988, and 1989, one-half of the excess of the taxpayer's pre-tax book income over alternative minimum taxable income (determined without regard to this preference and without reduction by net operating losses) is added back to AMTI. Book income, for this purpose, is the income of the taxpayer as shown in financial reports or statements filed with the Securities and Exchange Commission or other federal, state, or local regulators, or provided to shareholders, owners, or creditors. Under certain circumstances, earnings and profits may be substituted for book income. Book income is adjusted to reflect only the corporations included in the consolidated federal income tax return. Thus, income from most foreign subsidiaries and §936 corporations is excluded.

For taxable years beginning in 1990, the earnings and profits concept is scheduled to replace the book income concept. Under this concept, the AMTI of the taxpayer will be increased by 75% of the excess of adjusted current earnings and profits over the AMTI (before this adjustment). If, however, AMTI (before this adjustment) exceeds the amount of adjusted current earnings and profits, then AMTI is reduced by 75% of such difference.

(m) Possessions Income. In the case of a corporation eligible for a credit under §936, AMTI will not include any income that is eligible for a §936 credit.

After a corporation's taxable income has been recomputed with the adjustments described in the preceding paragraphs, the amount of the items of tax preference is added back to the recomputed taxable income to arrive at the AMTI. The items of tax preference for a corporation are:

(a) Depletion. With respect to each property, the excess of the deduction for depletion allowable under §611 over the property's adjusted basis of the property at the end of the taxable year.

(b) Intangible Drilling Costs. The amount by which the excess intangible drilling costs of the taxpayer exceed 65% of the taxpayer's net income for the taxable year from oil, gas, or geothermal properties.

(c) Bad Debt Reserves. For certain financial institutions, the excess of the deduction allowable for a reasonable addition to a reserve for bad debts over the amount allowable under the experience method.

(d) Charitable Contributions of Appreciated Property. The amount by which a deduction under §170 would be reduced if all contributed property were taken into account at its adjusted basis.

(e) Tax-Exempt Interest. Tax-exempt interest on private activity bonds issued after August 7, 1986.

(f) Pre-TRA 1986 Accelerated Depreciation and Amortization. For property placed in service before 1987, the amount which would be treated as an item of tax preference under either §§57(a)(2), 57(a)(3), 57(a)(4) or 57(a)(12), as in effect prior to the TRA 1986.

Section 59(e) provides a corporation with the option of electing, for regular tax purposes, minimum tax treatment for circulation expenditures, mining development and exploration costs and intangible drilling costs. That is, the taxpayer may elect, for regular tax purposes, to treat these expenditures and costs as capital expenditures and costs and amortize them ratably over a 10-year period (three years in the case of circulation expenditures). If the taxpayer makes this election then, with respect to these expenditures and costs, no adjustments or preference items will result for AMT purposes.

Once AMTI has been computed, it is reduced by the exemption amount to arrive at the alternative minimum tax base. The exemption amount for corporate taxpayers is $40,000. This amount, however, is phased out by 25 cents for each $1 once AMTI reaches certain levels. The phase-out begins at $150,000 and the entire $40,000 exemption amount is phased out when AMTI reaches $310,000.

The tentative alternative minimum tax is equal to 20% of the alternative minimum tax base. The excess of the tentative alternative minimum tax over the regular tax for the taxable year is the taxpayer's net minimum tax liability.

Note that the only non-refundable credits allowed against the alternative minimum tax are the alternative tax foreign tax credit and the investment tax credit (ITC) carryovers and transition-rule ITC. The alternative tax foreign tax credit, however, may offset tentative minimum tax liability only up to 90%, and the ITC carryovers and transition-rule ITC may offset only up to 25% of tentative minimum tax liability.

Any nonrefundable credit that fails to yield a regular tax benefit in the current taxable year due to the imposition of the alternative minimum tax is available as a credit carryover, provided a carryover for such credit is permitted under the normal Code rules. The mechanism utilized to accomplish this result is to limit the allowance of the aggregate amount of the nonrefundable credits against the regular tax in any year to the excess of the regular tax over the tentative minimum tax. In other words, to the extent incentive credits do not yield a tax benefit due to the imposition of the minimum tax, they are also disallowed for regular tax purposes, resulting automatically in a carryover.

Finally, the TRA 1986 introduced the alternative minimum tax credit. This credit along with the adjustment mechanism utilized in computing AMTI (*see* §§56 and 58) are intended to coordinate the regular tax and the minimum tax systems so that a taxpayer is not disadvantaged by being on the minimum tax system in one year and the regular tax system in another. The minimum tax credit provides that, if a taxpayer is subjected to the alternative minimum tax in any taxable year, that portion of the taxpayer's net minimum tax liability that is attributable to "deferral preferences" may be carried over to subsequent

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

taxable years and utilized against the taxpayer's regular tax liability on a cumulative basis. The minimum tax credit, however, may not reduce the taxpayer's regular tax below tentative AMT in any taxable year.

III. Detailed Analysis

A. Introduction to Corporate AMT

At early stages of the process leading to the enactment of the 1986 TRA, certain private organizations published reports that over 100 major corporations which reported profits to their shareholders in 1981-85 paid no income taxes in one or more of those years. The resulting criticism of the U.S. tax system led to a call by various congressional leaders for the enactment of a stiff minimum tax which would ensure that corporations paid their "fair share" of tax. In view of this and the ultimate inclusion of a book income adjustment by the Act (to be replaced by an accumulated current earnings adjustment in 1990) in the minimum tax base, it is fair to say that the enactment of corporate alternative minimum tax by the TRA 1986 is a direct congressional response to a growing public perception that highly profitable corporations with substantial economic income were paying little or no tax.

Several factors combine to make the corporate alternative minimum tax (AMT) perhaps the most significant reform in the entire Tax Reform Act of 1986:

(i) The predecessor of the corporate AMT, the add-on minimum tax, was in the nature of a penalty tax imposed on the use of a handful of tax incentives. In view of the structure, the low rate (15%) and the narrow base, this tax was not regarded as a significant factor in corporate tax planning. The revised corporate AMT is the exact opposite: its structure, the rate of tax (20%) and the tax base combine to make it a very stiff tax. More ominously though, besides allowing little or no room for planning, it imposes on corporate tax planners the hardship of dealing with enormous complexity, administrative burden, and recordkeeping responsibilities.

(ii) The TRA 1986 broadened the minimum tax base for both corporate and noncorporate taxpayers to include many tax incentives, *e.g.*, the completed contract method of accounting, installment sales, tax-exempt interest, passive losses, charitable contributions of appreciated property, etc. While inclusion of these and other traditional tax incentives in the minimum tax base is significant, the inclusion of the book income adjustment (accumulated current earnings beginning in 1990) is revolutionary in that it ensures that AMT will be the predominant tax for many corporations.

(iii) The corporate AMT imposes a significant new tax burden on corporate taxpayers. The budget estimates indicated that the corporate AMT was expected to raise over $22 billion in revenues in fiscal years 1987 through 1990.[34]

Although the introduction of AMT was new to the corporate tax area, the AMT was not new to the tax scene. As noncorporate taxpayers have been subject to AMT since 1978, the 99th Congress had a wealth of experience to draw upon when considering the imposition of this tax on corporations. The lessons learned from this experience become evident when one considers the considerable restructuring and expansion that the AMT went through for both corporate and noncorporate taxpayers. As discussed below, the restructuring and expansion of the AMT is characterized by a number of novel features introduced by the Tax Reform Act of 1986 to the AMT system.

(a) The 1986 Act extended the rationale underlying AMT to new limits. The traditional role of AMT had been to ensure that all taxpayers pay a minimum amount of tax. The message conveyed by the 1986 Act changes, however, appears to be that all taxpayers with substantial economic income must pay a minimum amount of tax and that no taxpayer will derive more than a limited amount of tax benefit from tax incentives.

(b) The Alternative Minimum Tax (AMT), as revised by the 1986 Act, may be viewed almost as a back-door enactment of a flat tax system. It has all three elements that characterize a flat tax system:

(i) The AMT provides a baseline standard against which every corporate taxpayer must measure its tax liability even though it may not be subject to AMT. In practice, however, the AMT is designed to apply to taxpayers with substantial economic incomes that use tax credits and other tax incentives [35] to reduce their tax liabilities below a 20% (the minimum tax rate) effective rate of tax.[36]

(ii) The AMT provides a single rate of tax (20%). Arguably, this rate is rather high to suit a flat tax system. Remember, however, that, given the revenue needs, the tax rate in a flat tax system is a direct function of the tax base. Congress could have lowered this rate had it chosen to further broaden the AMT base.

(c) The AMT applies a single rate to a tax base which attempts to define true economic income. The AMT base, under the 1986 Act changes, makes a much more serious attempt to define true economic income than the prior version of corporate minimum tax. For example, the post-1986 TRA corporate AMT base includes rapid depreciation on all personal property; tax-exempt interest; mining development and exploration costs; intangible drilling and development costs; charitable contributions of appreciated property; and the book income adjustment. Further, it disallows the completed contract method of accounting; the installment sales method of reporting income; and certain passive activity losses. Especially, the book income adjustment (accumulated current earnings in 1990 and subsequent years) ensures that the corporate minimum tax base will include a taxpayer's true economic income.

(d) Another feature introduced by the 1986 Act is to make the AMT a tax system unto itself, entirely distinct from, and running parallel to, the regular tax system. Thus, after the 1986 TRA, corporations are subject to a two-track

[34] H.R. Rep. No. 841, Vol. II, 99th Cong., 2d Sess. p. II-862 (1986) ("Conference Report").

[35] The tax incentives which will give rise to AMT liability are those enumerated in §§56, 57 and 58.

[36] Note that, due to a relatively small differential between the top marginal rate of regular tax (34%) and the AMT rate (20%), only a marginal use of tax incentives may trigger the AMT.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tax system. Any taxpayer who uses an incentive credit or other incentive item may find that it is obligated to keep two sets of books: one for regular tax purposes and one for AMT purposes, not only in the year of the use but also from year-to-year. For example, if a corporate taxpayer places an asset in service in 1987 and takes depreciation deductions under the ACRS, it will be advisable for it to maintain two depreciation schedules with respect to the asset, *i.e.*, one under the ACRS and one under the Alternative Depreciation System of §168(g). The schedule under §168(g) must compute the taxpayer's tentative AMT from year-to-year until the asset has been completely written off. What is true of depreciation deductions is also true of most other adjustments and preferences, *e.g.*, net operating losses, the completed contract method of accounting, and mining development and exploration costs.[37] Also, for minimum tax purposes, taxpayers will have to keep a running record of: (i) the adjusted bases of assets (based on deductions allowed for AMT purposes) to compute the gain or loss to be taken into account in computing the AMTI upon the disposition of such assets, (ii) the minimum tax credit carryovers until the credits are fully absorbed, and (iii) any alternative tax foreign tax carryovers.

(e) Finally, the revised AMT deals with an inequity inherent in the prior version of AMT that applied to noncorporate taxpayers: if a taxpayer was subject to AMT, the taxpayer never got the amount of regular tax benefit from the preferences (giving rise to the AMT) which the taxpayer would have obtained if those preferences had not received preferential treatment in the first place. Under pre-1986 TRA law, for instance, if a taxpayer took a current deduction for mining exploration and development costs, he was required to include 90% of such costs in the AMT base. If this taxpayer never again became subject to AMT, not only would 90% of mining exploration and development costs go unamortized for AMT purposes, but also the taxpayer would experience the loss of the regular tax benefit in the year of deduction because the imposition of AMT was permanent. This was also true for depreciation deductions and other deferral preferences. Thus, for example, a noncorporate taxpayer was required, for each year of the life of a depreciable asset, to include depreciation over and above the baseline deduction as a preference item and pay minimum tax on it. When the depreciation deductions for regular tax purposes fell below the baseline deductions, however, no negative adjustments were made to the AMT base and, consequently, the asset was never fully amortized for AMT purposes. The revised AMT, as it applies to both corporate and noncorporate taxpayers, eliminates this inequity by coordinating the regular and minimum tax systems. It employs two mechanisms to achieve this end: (i) an adjustment mechanism, and (ii) the alternative minimum tax credit.

The adjustment mechanism provided in §§56 and 58 requires the taxpayer to substitute minimum tax treatment for regular tax treatment of certain items. This will permit taxpayers to make negative adjustments. Consequently, in the case of depreciation deductions, for example, a taxpayer will be able to take a greater depreciation deduction for AMT purposes in later years than for regular tax purposes thereby compensating the taxpayer for the minimum tax imposed in earlier years.

The revised AMT also allows taxpayers a credit against regular tax in subsequent years for the net AMT attributable to deferral items. Consequently, a taxpayer that takes a current deduction for mining exploration and development costs against regular tax and pays AMT will be able to carry credit for payment of the AMT over to subsequent years and use it against regular tax.

The adjustment mechanism and the AMT credit are designed to ensure that a taxpayer is not disadvantaged by being on the AMT system in one year and on the regular tax system in another.

B. Computation of Net AMT Liability

As stated earlier, §55 imposes on corporate taxpayers an alternative minimum tax equal to the excess of the tentative minimum tax over the regular tax. Thus, although the alternative minimum tax is, in effect a true alternative tax in that it is imposed only if it exceeds the regular tax for the taxable year, technically, the regular tax continues to be imposed and the amount of net minimum tax is the excess of the tentative alternative minimum tax over the regular tax for the taxable year.

The tentative minimum tax is obtained by multiplying the AMT base by 20% and subtracting the AMT foreign tax credit therefrom. The tentative minimum tax is then compared to the taxpayer's regular tax (net of regular tax foreign tax credit) to arrive at the net AMT liability.

The AMT base is computed by subtracting the exemption amount from alternative minimum taxable income. Alternative minimum taxable income is obtained by making certain adjustments to regular taxable income and adding back the sum of the items of tax preference.

The steps involved in the computation of net AMT liability are discussed below.

1. Alternative Minimum Taxable Income (AMTI)

As previously indicated, the first step in determining the AMT base is computing "Alternative Minimum Taxable Income (AMTI)." "Alternative Minimum Taxable Income" means the taxpayer's taxable income for the taxable year, adjusted as provided in §§56 and 58 and increased by the amount of the taxpayer's §57 items of tax preference.[38] Thus, AMTI is determined in the same manner as taxable income for regular tax purposes, but with two types of modifications:

(i) adjustments are made to certain accounting practices and items of income and deduction to eliminate the tax preference or tax incentive element inherent in the treatment accorded to such accounting practices and items of income and deductions for regular tax purposes.

(ii) certain preference items, *i.e.*, exclusions from, and deductions taken against, gross income for regular tax purposes, are restored to AMTI.

[37] Not all preferences and adjustments impose this burden on taxpayers. Some items, which enter into the AMT base, are fully disposed of in the year they arise, *e.g.*, tax-exempt interest, gain on installment sales, etc.

[38] §55(b)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The concept of "adjustments" was introduced by the TRA 1986. Some tax incentives which were labeled as "items of tax preference" under pre-1986 TRA law were reclassified as adjustments, *i.e.*, depreciation deductions, amortization deductions for pollution control facilities, mining exploration and development costs. In addition, certain items of adjustment were introduced by the TRA 1986, *i.e.*, the disallowance of the installment method of reporting, the disallowance of the completed contract method of accounting, and the disallowance of certain passive losses.

The label of "tax preference," however, was not discarded. Section 57, which traditionally has set forth the items of tax preference retains some of the items (*i.e.*, those that have not been repealed or redesignated as adjustments) that constituted tax preferences under pre-1986 TRA law. Section 57 also includes two items of tax preference added by the TRA 1986: (i) tax-exempt interest, and (ii) charitable contributions of appreciated property.

Note: The terms "adjustments" and "tax-preferences" are not mere labels. As explained below, the bifurcation of tax incentives (other than incentive credits) into "tax preferences" and "adjustments" by the 1986 Act has a profound significance. Prior to the 1986 Act, under the AMT regime as it applied to noncorporate taxpayers, tax incentives (other than incentive credits), which involved merely a deferral of tax [39] were lumped together with tax incentives (other than incentive credits) which involved permanent reduction or avoidance of tax [40] and were called tax preference items.

The problem was not that both types of incentives were referred to as items of tax preference. Rather, the problem stemmed from the fact that both types of incentives received similar treatment in the computation of AMTI. This gave rise to inequitable results because, in the case of deferral incentives, when a taxpayer took "up-front" or accelerated deductions, he was exposed to AMT. In later years when the expenditure gave rise to income, the taxpayer was again subjected to regular tax on this income, without any compensating adjustment for the AMT imposed earlier. Thus, the AMT in such cases assumed a penal character because, although in using a deferral incentive the taxpayer was merely deferring regular tax, the AMT imposed, nonetheless, represented a final tax obligation.

Example: Suppose an individual taxpayer incurred $600X in circulation expenditures in 1984 and elected to take a current deduction under §173(a). The expenditures produced an additional income of $500X each in 1985, and 1986. Suppose further that the taxpayer was in the 50% tax bracket for all these years but that, in 1984, due to the circulation expenditures preference and some other preferences, the taxpayer was in an AMT position. In 1984, therefore, the taxpayer paid $80X in AMT on $400X in circulation expenditures preference. In each of taxable years 1985 and 1986, the taxpayer paid regular tax of $250X on an additional $500X of income attributable to the circulation expenditures incurred and deducted in 1984. Had the taxpayer elected to amortize the $600X circulation expenditures ratably over a three-year period under §58(i), the $200X of deduction in each of the taxable years 1985 and 1986 would have reduced the regular tax by $100X in those years. Thus, the taxpayer, by taking an up-front deduction in 1984 not only paid $80X in AMT but also paid an additional $100X in regular tax in 1985 and 1986.

To prevent this form of double taxation under the corporate AMT, the 1986 Act, besides providing for a minimum tax credit discussed below, divided the tax incentives (other than incentive credits) into "tax preferences" and "adjustments," providing different treatment for each in computing AMTI. Items of tax preference are positive adjustments to AMTI but only in the year in which they arise. On the other hand, not only may the adjustment items be negative (the deduction for AMT purposes may be larger than that for regular tax purposes), but also, they may have an impact on AMT beyond the year in which they first arise. This treatment of deferral incentives, in conjunction with the minimum tax credit, is aimed at ensuring that these items are not subjected to both the minimum and the regular tax.

Example: Suppose a personal holding company incurs $600X in circulation expenditures in 1987 and elects to take a current deduction under §173(a). Since the taxpayer is in an AMT position in 1987, it pays AMT of $80X (20% of $400X in circulation expenditures preference). Under the adjustment mechanism, however, the taxpayer is entitled to amortize fully $600X of circulation expenditures over a three-year period (*i.e.*, 1987, 1988, and 1989) for AMT purposes. Thus, in computing its AMTI in 1988 and 1989, the taxpayer is entitled to deduct $200X against AMTI. If the taxpayer is in an AMT position in both of these years, the deduction will reduce its AMT by a total of $80X (20% of $200X + 20% of $200X). In other words, the taxpayer will recoup the full amount of $80X paid in AMT in 1987. If the taxpayer is not in an AMT position in 1988 and 1989, the $80X of AMT paid in 1987 will be available as a credit against regular tax in 1988 and, if not fully absorbed in 1988, in subsequent

[39] For example, the current deduction under §173(a) for circulation expenditures is a deferral incentive because basically it enables the taxpayer to defer the tax attributable to income offset by the current deduction to future years when the income attributable to the expenditures is generated. Assume an individual taxpayer in the 50% tax bracket incurred a $300 circulation expenditure in 1984 and elected to amortize it over a 3-year period under §58(i). Assume further that this expenditure generated additional income of $200 in each of the three years (1984, 1985, 1986). Since $100 of this additional income in each of the three years was offset by the circulation expenditures deduction the taxpayer's net tax obligation attributable to the additional income in each of the three years is: 50% × ($200-$100) = $50. Thus, the taxpayer will pay an additional $50 in tax in 1984, 1985 and 1986. If, however, the taxpayer elected to take the entire $300 as a current deduction under §173(a) in 1984, his tax liability would have been reduced by $150 (50% x $300) in 1984. On the other hand, the taxpayer's tax liability attributable to the additional income would have been increased by $50 each in 1985 and 1986 because the deduction was utilized in 1984. Thus, the net effect of taking a current deduction would be to defer $100 of tax liability from 1984 to 1985 and 1986.

[40] The examples of such tax incentives included dividends excluded under §116 and the capital gains deduction. A taxpayer did not pay any regular tax attributable to such items. These items were included in the AMT base in the year in which they arose, however, and the taxpayer paid the minimum tax, provided he was in an AMT position. The AMT imposed on these items represented the taxpayer's final tax obligation.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

years until exhausted. Although the minimum tax credit may not reduce the regular tax below tentative AMT, the $200X deduction (pertaining to the amortization of circulation expenditures) available against AMTI in each of the taxable years 1988 and 1989 will ensure that the $80X credit will be fully absorbed by regular tax in 1988 and 1989.

Thus, it is clear that the AMT rules, as revised by the 1986 Act, are designed to ensure that a taxpayer is not subjected to both the AMT and the regular tax with respect to deferral incentives.

Not all of the adjustment items enumerated in §§56 and 58 involve deferral incentives. One adjustment, the alternative tax net operating loss deduction, is merely an adjustment to regular taxable income, and no more. Another, book income, is more in the nature of a tax preference than a tax adjustment. Similarly, all items of tax preference enumerated in §57 do not involve permanent reduction or avoidance of tax. For example, intangible drilling and development costs share the deferral characteristic of adjustment items. The minimum tax credit, however, recognizes this and includes these costs in items with respect to which the credit is available.

a. Items of Adjustment

The first step in determining AMTI is to recompute taxable income by providing a different and prescribed treatment to certain items in lieu of the treatment given such items for regular tax purposes. The taxpayer starts the computation of AMTI as if it were computing taxable income for regular tax purposes but with one difference: it disregards the regular tax treatment of items of adjustment and substitutes the treatment prescribed in §§56 and 58 for these items. This section deals with the items of adjustment and how they must be adjusted in arriving at AMTI.

(1) Accelerated Depreciation Deductions

(a) General

The 1986 Act completely revised the Accelerated Cost Recovery System (ACRS) of §168.[41] The statutory accelerated percentages for personal property, the Service's authority under which accelerated percentages were prescribed for real property, as well as the optional straight-line percentages prescribed for all ACRS property were eliminated. Under the revised ACRS, the taxpayers must compute their recovery deductions by applying a statutory formula.

(I) Revised ACRS

Revised §168 provides that, generally for all tangible property placed in service after 1986, a taxpayer's depreciation deduction must be determined by using (i) the applicable depreciation method, (ii) the applicable recovery period, and (iii) the applicable convention. The applicable depreciation methods are set forth in §168(b), the applicable classification and recovery period rules in §§168(e) and 168(c) respectively, and the rules pertaining to applicable convention in §168(d).

[41] *See* Chapter 4 for a detailed discussion of amendments made to the ACRS system by the 1986 Act.

The revised ACRS relies on the Asset Depreciation Range (ADR) guidelines for classifying assets. Generally, the ADR class lives are provided in Rev. Proc. 83-55, 1983-1 C.B. 745. The Conference Report also provides new ADR lives for some assets by either reclassifying assets or providing lives for assets not previously included in the ADR scheme. Under the post-1986 TRA ACRS, personal property is grouped into six classes having recovery periods that extend from 3 to 20 years (with no salvage value):

(i) The 3-year class includes property with an ADR class life of four years or less and certain race horses. Automobiles and trucks are excluded from this class even though they have a 4-year ADR life.

(ii) The 5-year class includes property with an ADR class life of more than four years but less than ten years. In addition, automobiles, light trucks, qualified technological equipment, computer-based central office switching equipment, certain renewable energy and biomass property, and research property are classified as 5-year property.

(iii) The 7-year class includes property with an ADR class life of at least 10 years and less than 16 years. This class also includes single-purpose agricultural and horticultural structures, railroad tracks, and property which does not have an ADR life and is not classified elsewhere.

(iv) The 10-year class includes property with an ADR life of at least 16 years and less than 20 years. Note that manufactured homes are not included in this class.

(v) The 15-year class consists of property with an ADR life of at least 20 years but less than 25 years. It also includes sewage treatment plants, telephone distribution plants and comparable equipment for two-way voice and data communication.

(vi) The 20-year class includes property with an ADR life of at least 25 years. It also includes municipal sewer pipes but excludes real property with an ADR midpoint of 27.5 years or more.

Real property is generally classified as either nonresidential real property or residential rental property. Nonresidential real property, which includes all real property that is not residential rental property and which does not have an ADR class life of less than 27.5 years, is assigned a recovery period of 31.5 years. Residential rental property, which includes manufactured homes and any building or structure generating at least 80% of its gross rental income from the rental of dwelling units, is assigned a recovery period of 27.5 years. Any other real property with an ADR class life of less than 27.5 years is generally assigned to the 20-year class.

Section 168(b) provides that property in 3, 5, 7, or 10-year class may be depreciated using a 200% declining balance method switching to the straight line method when the latter yields a larger deduction. Property in the 15 or 20-year class, however, must be depreciated by using a 150% declining balance method switching to the straight line method when the latter yields a greater deduction. The taxpayer may elect to use a straight-line method for property in any class.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Nonresidential real property and residential rental property must be depreciated using the straight-line method.

The applicable convention under revised §168(d) for all property other than real property is generally the half-year convention. A mid-quarter convention, however, must be used if the total bases of property which is subject to revised §168 and placed in service during the last three months of the taxable year exceeds 40% of the total bases of all such property placed in service during that entire taxable year. For real property, the applicable convention is the mid-month convention. Also, under the revised ACRS, the half-year convention has been modified to provide a half-year's depreciation allowance for the year in which property is disposed of where the disposition occurs during the recovery period.

Finally, as under pre-TRA 1986 law, salvage value is disregarded in determining the depreciation deductions.

(II) Alternative Depreciation System

Revised §168(g) provides an "alternative depreciation system" for various types of property which, under the pre-TRA 1986 ACRS, was depreciated under special rules. The types of property subject to the alternative depreciation system include:

(i) Foreign Use Property. This includes property that is used outside the United States for more than half of a taxable year. Satellites and other property used in space are not treated as foreign use property if launched from the United States by a U.S. person.

(ii) Tax-Exempt Use Property. This includes property leased to, or otherwise used by, a tax-exempt entity.

(iii) Tax-Exempt Bond Financed Property. This includes property financed with the proceeds of tax-exempt bonds. If a part of the property is financed through conventional sources, the costs for that portion may be recovered under the regular depreciation system.

(iv) Imported Property. If a foreign country restricts U.S. imports or otherwise engages in discriminatory trade practices, the President of the United States may, by Executive Order, mandate the application of the alternative depreciation system to property imported from such country. "Imported property" is defined as property that is manufactured outside the United States or property that has less than half of its value added within the United States.

The recovery period for property subject to the alternative depreciation system is generally the ADR class life. Real property is assigned a recovery period of 40 years. Personal property with no assigned class life under the ADR guidelines is assigned a 12-year recovery period. In addition, a few other assets have been assigned special recovery periods for purposes of the alternative depreciation system: 5 years for automobiles, light trucks and qualified technological equipment; 10 years for railroad tracks; 15 years for single-purpose agricultural structures; and 24 years for municipal wastewater treatment plants and telephone distribution plant and equipment.

The applicable depreciation method is the straight-line method for all classes of property. The half-year convention applies to personal property and the mid-month convention applies to real property.

The alternative depreciation system also applies in computing a corporate taxpayer's earnings and profits for a taxable year under the revised §312(k)(3), and in determining AMTI.

Finally, §168(g)(7) provides that, in lieu of using the accelerated or straight-line methods of depreciation over a property's regular recovery period, a taxpayer may elect to use the alternative depreciation system for any class of personal property placed in service during the taxable year. The election is made on a class-by-class and year-by-year basis. Thus, a taxpayer may choose to depreciate 3-year property under the regular depreciation system (ACRS) and 5-year property under the alternative system. The following year, the taxpayer may choose to depreciate 3-year property under the alternative depreciation system and 5-year property under the regular depreciation system (ACRS). Note that, once an election to apply the alternative depreciation system to an item of property in a particular class is made, it applies to all items of property in that class. An election to apply the alternative depreciation system to nonresidential real property and residential rental property, however, may be made on a property-by-property basis. An election under §168(g)(7), once made, may not be revoked.

(b) Definition

Technically, for all real and personal property placed in service after 1986,[42] the amount of the adjustment equals the excess of the depreciation deduction under ACRS for the taxable year over the deduction that would be allowable under the alternative depreciation system with one modification: the 150% declining balance method (in lieu of the straight line method) must be used for property other than §1250 property or any other property that is depreciated under §168 by using the straight-line method.[43] In practical terms, however, in computing AMTI, ACRS deduction for all property placed in service after 1986 is replaced by a deduction computed under the alternative depreciation system with appropriate modifications.

As noted above, the alternative depreciation system provides recovery periods which are longer than recovery periods under ACRS. For example, for purposes of the alternative depreciation system, 3-year recovery property may have an ADR class life of as long as four years; 5-year recovery property may have an ADR class life of as long as nine years; 7-year recovery property may have an ADR class life of as long as 15 years; and so on. Also, since, under ACRS, a 200% declining balance method is used for all property other than §1250 property, as opposed to the 150% declining balance method for AMT purposes, the

[42] The depreciation deduction adjustment may also apply to property placed in service before December 31, 1986, in one limited instance: when the taxpayer makes an election under §203(a)(1)(B) of the TRA 1986 to have the amendments made by the Act to ACRS apply to property placed in service after July 31, 1986 but before January 1, 1987.

[43] §56(a)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

depreciation deduction in the earlier years invariably is greater for regular tax purposes than for AMT purposes.

(I) Real Property

The alternative depreciation system assigns a recovery period of 40 years to both nonresidential real property and residential rental property as compared to 27.5 years for residential rental property and 31.5 years for nonresidential real property under ACRS. Real property, however, must be depreciated under the straight-line method under both ACRS and the alternative depreciation system. Thus, in computing AMTI, the depreciation deduction for all §1250 property is determined by using a 40-year recovery period under the straight-line method. Therefore, all real property will result in an upward adjustment to AMTI unless the taxpayer elects to use the 40-year recovery period for regular tax purposes.

(II) Personal Property

The depreciation deduction, for purposes of computing AMTI, is determined by using the asset's ADR class life and a half-year convention under the 150% declining balance method.[44] The taxpayer may switch to the straight-line method in later years when it would yield a larger deduction than that provided under the 150% declining balance method. The taxpayer, however, is not permitted to use the 150% declining balance method for any property if, for regular tax purposes, depreciation deductions for such property under §168 were computed using the straight-line method.[45] Since, for regular tax purposes, §168 provides shorter recovery periods and the 200% declining balance method of depreciation, in earlier years the taxpayer's deduction against regular taxable income will be greater than its deduction against AMTI, resulting in AMT liability. For example, if a taxpayer places an asset in the 3-year class with an ADR class life of four years in service in 1987, assuming a cost basis of $3000, depreciation deductions for regular tax and AMT in 1987 are computed as follows:

$$\text{Regular Tax} = \tfrac{1}{2}(200\% \times \$3{,}000) \div 3 = \$1{,}000$$

$$\text{AMT} = \tfrac{1}{2}(150\% \times \$3{,}000) \div 4 = \$563$$

Assuming, in the above example, the taxpayer elected to use the straight-line method in lieu of the double declining balance method for purposes of determining its depreciation deduction for regular tax purposes, the deductions for regular tax and AMT are as follows:[46]

$$\text{Regular Tax} = \tfrac{1}{2}(100\% \times \$3{,}000) \div 3 = \$500$$

$$\text{AMT} = \tfrac{1}{2}(100\% \times \$3000) \div 4 = \$375$$

Comment: Under the add-on minimum tax, preference items for C corporations included accelerated depreciation on real property only. The preference items for personal holding companies, however, also included accelerated depreciation on leased personal property. Under the corporate AMT, the depreciation adjustment for all corporate taxpayers applies to accelerated depreciation taken on all real and personal property. Also, under the pre-1986 TRA law, the depreciation preference was computed on item-by-item basis thus, precluding netting. Under the revised AMT, however, the mechanics of computing AMTI clearly permit netting.

The following example illustrates how the post-1986 TRA adjustment mechanism operates and how it differs from the earlier preference mechanism.

Example: Corporation X, a calendar year taxpayer, places two assets A and B in service in 1987. Asset A has a cost basis of $3,000; it belongs to 3-year class and has an ADR life of four years. Asset B has a cost basis of $5,000; it belongs to 5-year class and has an ADR life of seven years. The following table shows the depreciation deductions for both assets for regular tax and AMT purposes over the depreciable lives of the two assets.

Year		*Asset A (Cost Basis $3,000)*	*Asset B (Cost Basis $5,000)*	*Total Depreciation Deduction*
1987	Regular Tax	1,000	1,000	2,000
	AMT	563	536	1,099
1988	Regular Tax	1,334	1,600	2,934
	AMT	914	957	1,871
1989	Regular Tax	444	960	1,404
	AMT	609*	752	1,361
1990	Regular Tax	222	576	798
	AMT	609	612*	1,221
1991	Regular Tax	—	576*	576
	AMT	305	612	917
1992	Regular Tax	—	288	288
	AMT	—	612	612
1993	Regular Tax	—	—	—
	AMT	—	612	612
1994	Regular Tax	—	—	—
	AMT	—	307	307

Assumption 1: Asset A is in the 3-year class and has an ADR life of four years.
Assumption 2: Asset B is in the 5-year class and has an ADR life of seven years.

Assumption 3: The half-year convention is used throughout.

*In this year, the switch is made to the straight-line method to maximize deductions.

Observation 1: Note in the Total Depreciation Deduction column that X is allowed a depreciation deduction of $2,000 in computing its regular taxable income for 1987. In determining its AMTI for 1987, however, X is required to substitute $1,099 for $2,000 as its depreciation deduction, an upward adjustment of ($2,000-$1,099) $901 to AMTI. Assuming no other adjustments and preferences, X's AMTI for 1987 will be greater than its regular taxable income by $901 thus, exposing it to AMT.

[44] §56(a)(1)(A)(ii).
[45] *Id.*
[46] The taxpayer must use the straight-line method for AMT purposes since it used the straight-line method for regular tax purposes.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Observation 2: With respect to Asset A, note that the depreciation deduction available to X in computing regular taxable income is greater than the deduction available in computing AMTI in 1987 and 1988. This situation, however, is reversed in 1989, 1990 and 1991 when the AMTI deduction is greater than the regular tax deduction. Assuming that pre-1986 TRA law was in effect and that X was a personal holding company, it would have a depreciation preference of $437 ($1,000 - $563) in 1987 and of $420 ($1,334 - $914) in 1988. In 1989, 1990 and 1991, however, when the regular tax deduction falls below the minimum tax standard X would get no negative adjustment, *i.e.*, AMTI would not be reduced by the amount by which the minimum tax deduction exceeds the regular tax deduction. The adjustment mechanism under the revised AMT changes this. In 1989, for example, X gets a depreciation deduction of $444 in computing its regular taxable income, while it receives a deduction of $609 in determining AMTI, a downward adjustment of $165 ($609 - $444) to AMTI. It also gets downward adjustments of $387 ($609 - $222) in 1990 and $305 ($305 - $0) in 1991. Thus, the total upward adjustments in AMTI of $857 ($437 + $420) over the life of Asset A exactly equal the total downward adjustments in AMTI of $857 ($165 + $387 + $305) over the life of Asset A. This, in effect, means that the downward adjustments, which push the AMTI below the regular taxable income, will compensate X in later years either by offsetting other upward adjustments to AMTI or through the minimum tax credit mechanism for AMT imposed in 1987 and 1988.

Observation 3: Note the netting effect of the adjustment mechanism in 1989. For Asset A, X has a depreciation deduction of $444 for regular taxable income purposes and a deduction of $609 for AMTI purposes, a downward adjustment of $165 ($609 - $444) to AMTI. For Asset B, however, X has a depreciation deduction of $960 for regular taxable income purposes and a deduction of $752 for AMTI purposes, an upward adjustment of $208 ($960 - $752) to AMTI. On a combined basis, however, X only has an upward adjustment of $43 ($1,404 - $1,361) to AMTI in 1989 because the upward and downward adjustments are netted.

Observation 4: Note the necessity of keeping two different depreciation schedules for personal property placed in service after 1986: one for regular tax purposes and another for AMT purposes. If Asset A was the only asset placed in service by X in 1987 and 1991 was the first year X became subject to AMT, X would be required to go back to 1987 and reconstruct its depreciation schedule for Asset A for purposes of AMTI computations in 1991.

(C) Exceptions

Not all depreciable personal property placed in service after 1986 gives rise to adjustments to AMTI under §56(a)(1). Sections 56(a)(1)(B) and 56(a)(1)(C) provide certain exceptions. Specifically, the adjustment does not apply to:

(i) Sound recordings described in §48(r)(5).[47]

(ii) Films and video tapes which are generally depreciated under the income forecast method.[48]

(iii) Any property which is depreciated under the unit-of-production method or any other method of depreciation which is not expressed in terms of years.[49]

(iv) Any property with respect to which the taxpayer makes an election to depreciate under the alternative depreciation system.[50]

(v) Certain public utility property (within the meaning of §167(l)(3)(A)) if the taxpayer does not use a normalization method of accounting.[51]

(vi) Certain property placed in service after December 31, 1986, which qualifies for transitional relief and, therefore, is excepted from the application of the revised ACRS rules.[52]

(vii) Property which is expensed under §179.[53]

In all the cases enumerated above, the depreciation deduction allowed for computing regular taxable income will be the deduction allowable in computing AMTI. Consequently, these types of property will have no impact on a taxpayer's AMT liability.

(D) AMT Planning

Any corporation which finds itself in an AMT position in the current taxable year and which has placed certain depreciable assets in service during the year has certain planning options available to it. For instance, in the Example above, if X finds that it is pushed into an AMT position in 1987 by taking rapid write-offs (under the 200% declining balance method) on Assets A and B, it should consider electing under §168(b)(5) to apply a straight-line method to either or both A and B. If X elected to depreciate both assets A and B under a straight-line method, its depreciation deduction in computing regular taxable income for 1987 would be $1,000, whereas its deduction in computing AMTI would be $1099. This would not only eliminate any AMT exposure arising from depreciation of Assets A and B, but also would provide X with a $99 cushion to absorb upward adjustments in AMTI from other sources.

Where taxpayers are in an AMT position without regard to the depreciation deductions attributable to assets placed in service during the current taxable year, the §168(g)(7) election provides them with a tool to manage their AMT liability. Again, using X from the Example, if X has other preferences and adjustments in 1987 which expose it to AMT, X may elect under §168(g)(7) to depreciate both A and B under the alternative depreciation system. Thus, in 1987 X's depreciation deduction for regular tax purposes will be 1/2 (100% of 300/4) $375 for Asset A and 1/2 (100% of 5000/7) $357 for Asset B. Since the deduction for AMTI purposes is $1,099 for both A and B, X's AMTI for 1987 will be adjusted downward by (1099-375-357)=$367. Thus, X will be able to absorb $367 of upward adjustments to AMTI by electing to depreciate A and B under the alternative depreciation system.

[47] §§56(a)(1)(B) and 168(f)(4).
[48] §§56(a)(1)(B) and 168(f)(3).
[49] §§56(a)(1)(B) and 168(f)(1)(B).
[50] §§56(a)(1)(B) and 168(f)(1)(A).
[51] §§56(a)(1)(B) and 168(f)(2).
[52] §56(a)(1)(C).
[53] Senate Report, footnote 5, p. 522.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Comment: Electing under §168(g)(7) to depreciate property under the alternative depreciation system will always provide the taxpayer with a cushion to absorb upward adjustments in AMTI from other sources. This is because, while the recovery periods are the same for both regular tax and AMT purposes, the depreciation deduction for regular tax purposes must be computed using the straight-line method, whereas the 150% declining balance method is used in computing the depreciation deduction for AMT purposes.

Therefore, a judicious use of the elections under §§168(b)(5) and 168(g)(7) can be an invaluable tool in managing AMT liability, especially since these elections may be made on a class-by-class and year-by-year basis.

(2) Amortization of Pollution Control Facilities

(a) General

Section 169 provides that, with respect to any certified pollution control facility, a taxpayer may elect to amortize the amortizable basis of such property over a 60-month period. For corporate taxpayers, however, the election applies to only 80% of the amortizable basis.[54] The balance of 20% may be recovered through deductions under the ACRS.[55] Since the ADR class lives or the recovery periods under the ACRS of such facilities would be much greater than 60 months, the rapid write-offs provided by §169 have traditionally been treated as a tax preference item.

(b) Definition

For any certified pollution control facility placed in service after December 31, 1986, a corporation, in computing its AMTI for the taxable year, disregards the amortization deduction taken under §168 with respect to 20% of the basis of the facility and under §169 with respect to 80%, and substitutes a deduction computed under the alternative depreciation system of §168(g).[56] Under §168(g), the depreciation deduction for each pollution control facility must be computed by using the ADR class life of such property under the straight-line method. Thus, the upward adjustment in AMTI would equal the excess of the deduction taken under §§168 and 169(a) over the deduction computed under §168(g).

The discussion pertaining to the accelerated depreciation deductions adjustment in the preceding section generally applies to the certified pollution control facilities amortization adjustment also.

(3) Mining Exploration and Development Costs

(a) General

Under §§616 and 617, a taxpayer is permitted to treat expenditures incurred for development and exploration of a mine as expenses deductible in the year paid or incurred. For corporate taxpayers, however, this current deduction is limited to 70% of the mining development and exploration costs incurred during the taxable year.[57] But for §§616 and 617, these expenditures would receive the less favorable tax treatment of capitalization and amortization over the producing life of the mine, which would result in much smaller deductions spaced over many years.

(I) Mining Exploration Costs

Section 617(a) provides that a taxpayer may elect to deduct currently expenditures paid or incurred during the taxable year to ascertain the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas), provided such expenditures are incurred prior to the beginning of the development stage. The election does not apply to amounts which would not otherwise be allowable as a deduction for the taxable year. Accordingly, to the extent exploration expenditures are allocable to worthless property, they may be deductible under §165, but are not subject to a §617(a) election. The §617(a) election also does not apply to:

(i) Amounts for which a percentage depletion deduction would not be available under §613.[58]

(ii) Amounts incurred in the acquisition or improvement of depreciable property; however, a depreciation allowance may be claimed with respect to such amounts.[59]

(iii) Amounts incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas) located outside the United States.[60]

If a corporation makes an election under §617(a), it may deduct currently only 70% of mining exploration costs paid or incurred during the taxable year.[61] The balance of 30% must be capitalized and amortized ratably over a 60-month period beginning with the month in which such costs were paid or incurred.[62] No cost depletion is allowed with respect to mining exploration expenditures which are capitalized and amortized over a 60-month period.[63]

Regs. §1.617-1(a) provides that the development stage of a mine or other natural deposit will be deemed to begin at the time when, in consideration of all the facts and circumstances, deposits of ore or other mineral are disclosed in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. For example, core drilling expenditures paid or incurred by the taxpayer to ascertain the existence of commercially marketable ore are exploration expenditures. Also, expenditures for exploratory drilling from within a producing mine to ascertain the existence of what appears to be a different ore deposit qualify as exploration expenditures.

An election under §617(a) may be made by a taxpayer by deducting exploration expenditures on its income tax return for the first taxable year ending after September 12, 1966, for which it desires to deduct such expenditures.[64] A corporation choosing the current deduction option, however, must elect §617(a) treatment for all mining explora-

[54] §291(a)(5).
[55] §291(c)(1).
[56] §56(a)(5).
[57] §291(b)(1).
[58] §617(a).
[59] *Id.*
[60] §617(h).
[61] §291(b)(1).
[62] §291(b)(2).
[63] §291(b)(5).
[64] Regs. §1.617-1(c)(1)(i).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tion costs paid or incurred during the taxable year.[65] An election under §617(a) may not be made with respect to only a portion of such costs paid or incurred during the taxable year. Thus, a corporate taxpayer electing under §617(a) will deduct 70% of mining exploration costs paid or incurred during the taxable year currently and capitalize and amortize ratably over a 60-month period the balance of 30% of such costs. An election under §617(a) once made, cannot be revoked without the prior consent of the Commissioner.[66]

Mining exploration expenditures that are deducted partially under §617(a) and capitalized and amortized over a 60-month period partially under §291(b)(2) are subject to recapture as ordinary income under §1254.[67] To the extent §1254 does not apply, mining exploration expenditures deducted under §617(a) are subject to recapture as ordinary income under §617(d).[68] Mining exploration expenditures that are deducted under §617(a) are also subject to recapture under §617(b) when the mine reaches the production stage.

When a mine reaches the producing stage, §617(b)(1) provides two methods of recapture. Under the first method, the taxpayer must forego depletion on all mines or deposits reaching the producing stage during the taxable year until the amount of depletion which would have been allowed on each mine or deposit equals the amount of adjusted exploration expenditures with respect to such mine or deposit. Under the second method, the taxpayer may elect to include in gross income for the year an amount equal to the adjusted exploration expenditures with respect to all mines reaching the producing stage during that year. The amount included in gross income becomes part of the depletable bases of the respective mines; however, it is not considered to be gross income from the property for percentage depletion purposes. Adjusted exploration expenditures are defined as the exploration expenditures paid or incurred with respect to any property under §617(a) in all years reduced by: (i) the amount (if any) by which the deduction for percentage depletion, which would have been allowable for all years if no deduction for the exploration expenditures under §617(a) had been allowed, exceeds the actual depletion allowed for the corresponding years; (ii) the aggregate of all amounts included in gross income under §617(b) and §617(c); and (iii) the amount of gain to which §617(d) applies.

If a taxpayer does not make an election under §617(a) to currently deduct the mining exploration expenditures, such expenditures are capitalized and become part of the property's depletable basis.

(II) Mining Development Costs

Section 616(a) provides that a taxpayer may deduct all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well), provided the expenditures are paid after the existence of ores or minerals in commercially marketable quantities has been discovered. Section 616(a) does not, however, cover the cost of acquiring depreciable property. Regs. §1.616-1(a) provides that the development stage of a mine is reached when, taking into account all facts and circumstances, deposits of the minerals are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. The Service, in Rev. Rul. 69-540, 1969-2 C.B. 143, set down general guidelines for determining whether expenses are development expenditures. According to the ruling, development expenditures are those resulting directly from the mining process or the activity of making the mineral in place accessible for production operations through the removal of material, by the driving of shafts, tunnels, galleries and similar processes or activities. For §616(a) to apply, the mine must be in the development stage, expenditures must be for the purpose of preparing the mineral deposit for extraction, and the expenditures must not be for equipment or facilities which relate solely to the extraction of the mineral from the mine.

If a corporation exercises the option under §616(a) to currently deduct mining development costs paid or incurred during the taxable year, such deduction is limited to 70% of the costs by §291(b)(1). The balance of 30% must be capitalized and amortized ratably over a 60-month period beginning with the month in which such costs are paid or incurred.[69] No cost depletion is allowed with respect to mining development expenditures which are capitalized and amortized under §291(b)(2).[70]

Section 616(b) provides that a taxpayer, instead of deducting development costs currently, may elect to defer such costs. If an election under this subsection is made with respect to a mine, the excess of such costs incurred during the taxable year over net receipts is deductible ratably as the mineral benefits are produced and sold. This method of amortization is similar to cost depletion. Note, however, that the deferred development costs are not capitalized as mineral property costs for depletion purposes; the amortization on such costs is allowable as an ordinary deduction in addition to the depletion deduction in the years benefited. The election under §616(b) may be made on mine-to-mine basis.[71] It applies only to expenditures incurred during the taxable year for which it is made.[72] The election, however, must cover all development expenditures for the taxable year for each mine. The election, once made, is irrevocable.[73]

(b) Definition

Mining development and exploration costs paid or incurred after December 31, 1986, which are allowable as a current deduction in computing regular taxable income under §616(a) or 617(a) must, for purposes of computing AMTI, be capitalized and amortized ratably over a 10-year period beginning with the taxable year in which the expen-

[65] Regs. §1.617(c)(1)(iii).
[66] Regs. §1.617-1(c)(1)(ii).
[67] §§1254(a) and 291(b)(3).
[68] §617(d).
[69] §291(b)(2).
[70] §291(b)(5).
[71] Regs. §1.616-2(e)(2).
[72] Regs. §1.616-2(e)(1).
[73] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ditures are made.[74] Thus, if a corporation takes a current deduction under §616(a) or §617(a) for 70% of the mining development or exploration costs paid or incurred during the taxable year and amortizes the balance over a 60-month period, it will result in an upward adjustment to the corporation's AMTI for the taxable year.

Example: Corporation A incurs $1,000 in mining exploration expenditures on January 1, 1987 with respect to which it makes an election under §617(a). For purposes of computing its regular taxable income for 1987, A is entitled to a deduction of ($700 + [12 × $300 ÷ 60]) = $760. For purposes of computing A's AMTI, however, it is entitled to a deduction of ($1,000 × 10/100) = $100 in 1987. Assuming no other adjustments or preferences, A's AMTI for 1987 will be greater than its regular taxable income by ($760 − $100) = $660.

If a taxpayer suffers a loss with respect to a mining property (*e.g.*, it is abandoned as worthless) for which deductions have been taken under §616(a) or 617(a) for mining development or exploration costs then, for purposes of computing AMTI, the entire unamortized portion of such costs is deductible in the year of the loss.[75] The amount of this loss deduction in computing AMTI is subject to only one limit: it may not exceed the amount that would be allowable as a loss deduction under §165(a) had such costs remained capitalized.[76]

As stated earlier, mining exploration expenditures deducted under §617(a) are recaptured as ordinary income when the mine with respect to which such expenditures were incurred reaches the production stage or is disposed of. If the property is not disposed of, the recapture takes the form of either a denial of a depletion deduction or inclusion in gross income. Either way, the downside of taking a current deduction for exploration costs under §617(a) is that, in later years, gross income is increased by the amount of the deduction. Mining development expenditures involve similar mismatching of income and deductions because income is generally produced in year(s) subsequent to the year in which the development expenditures are incurred and deducted. Section 56(a)(2) neutralizes this tax deferral effect of current deductions under §§616(a) and 617(a) by requiring a 10-year amortization of mining exploration and development expenditures. By the same token, a taxpayer which pays AMT due to the mining exploration and development costs adjustment, is compensated in later years for the amount of such AMT in either of the following two ways. First, if the taxpayer is an AMT position, the 10% amortization deduction attributable to §616(a) and/or 617(a) costs deducted in an earlier year will adjust AMTI downward by 4% of such costs in each of the first following five years (assuming the costs were paid or incurred in the first month of the taxable year) and by 10% of such costs in each of the next five years.[77] This reduces the AMT the taxpayer would otherwise owe. Alternatively, if the taxpayer is not in an AMT position, the AMT credit stemming from the AMT imposed due to an adjustment made pursuant to §56(a)(2) will offset the regular tax in subsequent years until the credit is exhausted.

Finally, §59(e) provides a taxpayer with an option to eliminate the minimum tax impact of mining exploration and development costs. Under §59(e)(1)(E), a taxpayer may elect to amortize mining development and exploration costs ratably over a 10-year period for regular tax purposes. If this election is made, §56(a)(2) does not apply to such costs.

(c) AMT Planning

The upward adjustment to AMTI resulting from mining development and exploration costs deducted under §616(a) or 617(a) (or from any other §56 item for that matter) may not be undesirable (whether wholly or partially) in all cases. This is because a taxpayer may have downward adjustments to AMTI in the current year from other sources which may offset the upward adjustment. For example, the taxpayer may have placed certain depreciable property in service in prior years with respect to which it is taking deductions under the ACRS, or it may have deducted mining development or exploration expenditures under §616(a) or 617(a) in an earlier year which give rise to downward adjustments to AMTI in the current year. On the other hand, a current deduction under §616(a) or §617(a) may be wholly undesirable for one reason or another, *e.g.*, because it kicks in the phase-out of the exemption amount under §55(d)(3). Consequently, when a taxpayer incurs mining development or exploration costs, it must determine to what extent, if any, an upward adjustment to AMTI in the taxable year in question is undesirable, especially since it has important options at its disposal to manage the amount of such adjustment.

(I) Mining Exploration Costs

The taxpayer has the option not to elect under §617(a) to take a current deduction for mining exploration costs. If an election under §617(a) is not made, mining exploration costs are capitalized and become part of the depletable basis of the mining property. Alternatively, the taxpayer may elect under §59(e) to capitalize and amortize mining exploration costs ratably over a 10-year period beginning with the year in which such costs are paid or incurred. Some of the relevant considerations bearing upon these options are summarized below.

(i) If exploration costs are capitalized, they increase the taxpayer's depletable basis and, hence, the cost depletion deduction for regular tax purposes without any AMT exposure. Capitalization and the resulting increase in basis, however, will yield no benefit in terms of the size of the depletion deduction for regular tax purposes if the taxpayer claims percentage depletion. Provided the taxpayer claims percentage depletion, an election under §59(e) will yield an additional amortization deduction for regular tax purposes.

(ii) Since an election under §617(a) applies to all mining exploration costs paid or incurred during the taxable year,[78] the taxpayer may not capitalize a portion of

[74] §56(a)(2)(A)
[75] §56(a)(2)(B)
[76] *Id.*
[77] The yearly adjustment in AMTI for the first five years is 4% because 30% of the costs are amortized over a 60-month period and, therefore, yield a yearly deduction equal to 6% of such costs against regular taxable income in each of the first five years.

[78] §617(a)(2)(B)

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

such costs under §263. An election under §59(e), on the other hand, permits the taxpayer to capitalize and amortize ratably over a 10-year period *any portion* of mining exploration costs.[79] Note, however, that 30% of the portion of such costs to which a §59(e) election does not apply, nevertheless, will have to be capitalized and amortized ratably over a 60-month period under §291(b)(2).

(iii) An election to currently deduct mining exploration costs under §617(a) applies to such costs paid or incurred not only in current taxable year but also in any subsequent taxable year.[80] Consequently, if mining costs paid or incurred are deducted under §617(a) in the current taxable year, a portion of such costs paid or incurred in a subsequent taxable year may not be capitalized unless the Commissioner's consent is obtained to revoke the §617(a) election. On the other hand, since an election under §59(e) may be made with respect to a portion of mining exploration costs paid or incurred during a taxable year, it is obviously not binding on such costs incurred during a subsequent taxable year. Thus, if the taxpayer chooses to elect under §59(e), mining exploration costs incurred in a subsequent taxable year may be deducted under §617(a) or may be capitalized under §263.

(iv) If mining exploration expenditures are capitalized and amortized pursuant to a §59(e) election, the deducted expenditures shall, upon a subsequent disposition of the mining property, be recaptured as ordinary income under either §1254 or §617(d).[81] No such recapture, however, will be required if such costs are capitalized under §263 and recovered as depletion deductions.

Comment: Since, in taxable years beginning after 1987, capital gains and ordinary income will be taxable at the same tax rates, the significance of recapture has been reduced considerably. If a taxpayer chooses to capitalize only a portion of mining exploration costs under §59(e), must the taxpayer capitalize the balance of such costs under §263 or, does it have the option to partially deduct the balance under §617(a) and partially capitalize it under §291(a)(2)? If the taxpayer may deduct the balance partially under §617(a), it will be able to manage the amount of upward adjustment in AMTI in precise terms by controlling the amount of mining exploration costs that is subjected to the §59(e) election. Since §617(a)(2)(B) provides that an election under §617(a) applies to all mining exploration costs paid or incurred during the taxable year, there is a tension between §617(a) and §59(e). Since §59(e)(3) clearly provides that no other Code sections apply to amounts subject to an election under that section, however, it appears that §617(a)(2)(B) should not preclude capitalization of a portion of exploration costs under §59(e) while the balance is partially deducted under §617(a) and partially capitalized under §291(b)(2).

(II) Mining Development Costs

Although mining development costs are capital in nature, §616(a) permits taxpayer to take a current deduction for such costs. In lieu of taking a current deduction, however, the taxpayer may elect under §616(b) to capitalize such costs with respect to each mine or deposit and amortize them ratably as the units of the produced ore or minerals benefiting from such costs are sold.[82] Note that, although the deferred mining development costs are not capitalized for depletion purposes, they are considered part of the adjusted basis for all other purposes.[83] The taxpayer also has the option to elect under §59(e) to capitalize and amortize any portion of mining development costs paid or incurred during the taxable year. Some of the relevant considerations bearing upon a choice between an election under §616(b) or a §59(e) election are summarized below.

(i) If an election under §616(b) is made, only that portion of the mining development costs may be deferred which exceeds the net receipts from the ore or the minerals from the mine received or accrued during the same taxable year as the costs were paid or incurred.[84] The mining development costs not in excess of such receipts must be deducted currently under §616(a), subject to the 70% limit under §291(b)(1). An election under §59(e) permits a taxpayer to capitalize all mining development costs regardless of the net receipts restriction.

(ii) An election under §616(b) may be made on a mine-by-mine basis. An election under §59(e), on the other hand, may be made with respect to any portion of mining development expenditures paid or incurred during the taxable year with respect to a particular mine.

(iii) The taxpayer may use both options and a current deduction under §616(a) concurrently: it may capitalize mining development costs with respect to one mine under §616(b), it may capitalize a portion of mining development costs with respect to other mines under §59(e), and deduct currently under §616(a) 70% of the balance of mining development costs with respect to other mines. Thirty percent of the balance of such costs will, of course, be capitalized and amortized under §291(b)(2). A skillful manipulation of these choices can ensure that the taxpayer will derive maximum benefit from mining development costs paid or incurred during the current taxable year for regular tax purposes without suffering any AMT detriment.

(4) Certain Long-Term Contracts

(a) General

The Tax Reform Act of 1986 modified the special accounting rules that apply to taxpayers providing goods or services under long-term contracts. Prior to the 1986 Act, a taxpayer with income and expenses from long-term contracts could use the traditional cash or accrual methods of accounting. At the taxpayer's election, however, income and expenses attributable to long-term contracts could also be reported under either of two special methods of accounting: (i) the percentage of completion method, or (ii) the completed contract method.

A long-term contract is a building, installation, construction, or manufacturing contract that is not completed

[79] §59(e)(4)(A)
[80] *Id.*
[81] §59(e)(5)
[82] Regs. §1.616-2(a)
[83] §616(c)
[84] Regs. §1.616-2(a)

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

within the taxable year in which it is entered into. A manufacturing contract qualifies as a long-term contract, however, only if it involves the manufacture of either unique items of a type not normally carried in the finished goods inventory of the taxpayer, or items normally requiring more than 12 months to complete.[85]

Under the percentage of completion method, income is recognized according to the percentage of the contract that is completed during each taxable year. The determination of the portion of the contract completed during each taxable year may be made by either (i) comparing costs incurred during the year to the total estimated costs to be incurred under the contract, or (ii) comparing the work performed during the year with the estimated total work to be performed under the contract.[86] All costs attributable to a long-term contract are deductible in the year incurred.

Under the completed contract method, the entire gross contract price of a long-term contract is included in income in the taxable year in which the contract is completed and accepted. Also, all costs properly allocable to a long-term contract are deducted in the year of completion.

Under the amendments made by the TRA 1986, for long-term contracts entered into after February 28, 1986, taxpayers may elect to compute income from long-term contracts under one of two methods: (i) the percentage of completion method, or (ii) the percentage of completion-capitalized cost method. Except for certain real property construction contracts, these are the exclusive methods under which long-term contracts may be reported.

As under pre-1986 TRA law, taxpayers may elect to use the percentage of completion method for long-term contracts. The 1986 Act, however, makes several changes to the percentage of completion method:

(i) The exclusive method of determining the portion of the contract completed during the taxable year is the cost comparison method. The work-performed comparison method is no longer permissible.[87]

(ii) Contract costs are to be determined in accordance with the extended period long-term contract regulations (Regs. §1.451-3(b)(3)).[88]

(iii) Interest must be allocated to the contract in accordance with the interest capitalization rules.[89]

(iv) Independent research and development costs; costs of unsuccessful bids and proposals; and marketing, selling and advertising costs are not allocable to long-term contracts.[90]

The percentage of completion-capitalized cost method is a hybrid method which combines the percentage of completion method and taxpayer's normal method of accounting. Under this method, 40% of the long-term contract is reported under the percentage of completion method as described above.[91] The remaining 60% is reported under taxpayer's normal method of accounting.[92] Thus, 60% of the gross contract income will be recognized, and 60% of the contract costs will be deducted at the time required by taxpayer's method. For example, if the taxpayer uses the completed contract method of accounting, these items will be taken into account upon completion of the contract. If the taxpayer uses an accrual method (*e.g.*, accrual shipment method), such contract items will be taken into account at the time of shipment.[93]

(b) Definition

For purposes of computing AMTI, any long-term contract entered into after February 28, 1986, must be accounted for under the percentage of completion method as modified by the 1986 Act. Thus, a taxpayer using the percentage of completion-capitalized cost method for regular tax purposes will generally be required to make adjustments in AMTI. For instance, a taxpayer accounting for 40% of a long-term contract under the percentage of completion method and 60% under the completed contract method for regular tax purposes will be required to adjust AMTI upward in the early years. In the final year of the contract, however, when income for the 60% portion of the contract is recognized, there will be a downward adjustment in AMTI.

Any adjustments to AMTI may be eliminated by using the percentage of completion method for regular tax purposes.

(5) Installment Sales of Certain Property

Prior to the Tax Reform Act of 1986, gain from certain sales of property in exchange for which the seller received deferred payments was reported on the installment method unless taxpayer elected otherwise. Eligible sales included dispositions of personal property on the installment plan by a person who regularly sold or otherwise disposed of personal property on the installment plan, and other dispositions of property including publicly traded property, where at least one payment was to be received after the close of the taxable year of the disposition.

The TRA 1986 modified the installment sales rules significantly. It enacted the proportionate disallowance rule which limits the use of installment method based on a proportion of taxpayer's outstanding debt. The rationale behind this rule is that if a taxpayer holds installment obligations, part or all of his debt is related to those obligations. Either the extension of credit by the taxpayer necessitates borrowing or it enhances the taxpayer's ability to borrow. Section 453C, therefore, limits the amount of gain that may be reported under the installment method from the following types of sales:

(i) sales made after February 28, 1986, of personal property by a person who regularly sells or otherwise disposes of the same type of personal property;

[85] Regs. §1.451-3
[86] Regs. §1.451-3(c)(2)
[87] §460(b)(2)(A)
[88] §460(c)(1)
[89] §460(c)(3)
[90] §460(c)(4)
[91] §460(a)(1)(A)
[92] §460(a)(1)(B)
[93] For a discussion of the revised rules governing long-term contracts, *see* Chapter 20, *supra*.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(ii) sales made after February 28, 1986, of real property held by the seller for sale to customers in the ordinary course of business; and

(iii) sales made after August 16, 1986, of real property used in the seller's trade or business or property held for the production of rental income, provided the sale price exceeds $150,000.

The proportionate disallowance rule operates by first determining the amount of a taxpayer's "allocable installment indebtedness" for each taxable year and treating such amount as a payment immediately before the close of the taxable year on "applicable installment obligations" that arose during that taxable year and that are outstanding at the end of the taxable year.[94] As a result, a portion of the taxpayer's debt is treated as a payment toward its installment obligations. "Applicable installment obligation" is defined in §453(e) as an obligation arising from a sale of a type described in the preceding paragraph on an installment basis. The amount of "allocable installment indebtedness" is computed in accordance with the formula provided in §453C(b). The proportionate disallowance rule does not apply to the following transactions:

(i) disposition by an individual of personal use property;[95]

(ii) disposition of any property used or produced in the trade or business of farming;[96]

(iii) at the election of the taxpayer, sales of timeshares and unimproved lots of land, provided the conditions of §453C(e)(4) are met; and

(iv) sales of tangible personal property by the manufacturer of the property to a dealer, but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed price after no longer than a 9-month period following the sale, and certain other conditions specified in §811(c)(2) of the Act are satisfied. The additional requirements of §811(c)(2) of the Act include: (i) for the taxable year in question and the preceding taxable year, the aggregate face amount of the obligations arising from qualified sales by the manufacturer must be at least 50% of the total sales to dealers giving rise to such obligations; and (ii) the requirements of §811(c)(2) of the Act must be met by the taxpayer in its first taxable year beginning after October 22, 1986. For purposes of this provision, obligations issued before October 22, 1986, are treated as meeting the applicable requirements if such obligations are conformed to the requirements of §811(c)(2) of the Act by December 20, 1986.

Taxpayers who sell property on a "revolving credit plan" are not permitted to use the installment method. Such taxpayers must treat all payments as received in the year of disposition.[97] "Revolving credit plan" is defined in Regs. §1.453-2(d).

Persons who sell stock or securities that are traded on an established securities market or, to the extent provided in regulations, property of a kind regularly traded on an established market, are not permitted to use installment method.[98] All payments made to these persons will be treated as received in the year of disposition. The regulations are expected to provide that, where sales take place on an established market and settlement generally occurs several days after the trade date, both cash and accrual basis taxpayers will recognize gain or loss on the day the trade is executed and not on the day settlement occurs.[99]

The disallowance of the installment method for sales on revolving credit plans and for sales of publicly traded property is effective for sales of property made after December 31, 1986. The proportionate disallowance rule is effective as of January 1, 1987, for sales made on or after March 1, 1986. A taxpayer will treat installment obligations arising between March 1, 1986, but before the first taxable year ending after December 31, 1986, as having arisen during the first taxable year of the taxpayer beginning after December 31, 1986.

For purposes of computing AMTI, gain from any disposition after March 1, 1986, of property to which the proportionate disallowance rule of §453C applies, is to be determined without regard to the installment method and all payments are deemed to have been received in the year of disposition.[100] Thus, to the extent the proportionate disallowance rule permits the deferral of gain recognition upon the sale of personal and real dealer property and certain other business or rental realty, AMTI will be adjusted upward by an amount which equals the deferred gain. There will be no adjustments made to AMTI, however, in cases of installment sales made by a corporation to which the proportionate disallowance rule does not apply:[101]

(i) dispositions of any property used or produced in the trade or business of farming,

(ii) sales of timeshares and unimproved lots of land, and

(iii) certain sales of tangible personal property by manufacturers.

Comment: Although the revised AMT rules are not effective until 1987, §56(a)(6) disallows the use of the installment method for sales made after March 1, 1986. Thus, taxpayers will recognize the entire gain from an applicable sale (*i.e.*, a sale subject to the proportionate disallowance rule) made after March 1, 1986, but within the taxpayer's taxable year beginning before January 1, 1987, for purposes of computing pre-TRA 1986 AMT. In later years when gain is recognized for regular tax purposes, however, no adjustment to AMTI will result.[102]

(6) Circulation Expenditures

(a) General

Section 173 allows a taxpayer a current deduction for all expenditures to establish, maintain, or increase the

[94] §453C(a)
[95] §453C(e)(1)(B)(i)
[96] §453C(e)(1)(B)(ii)
[97] §453(j)(1)
[98] §453(j)(2)
[99] Senate Report, p. 132.
[100] §56(a)(6)
[101] §56(a)(6)(B) and §701(f)(3) of the Act
[102] Senate Report, footnote 8, p. 526.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

circulation of a newspaper, magazine, or other periodical, for the taxable year in which such expenditures are incurred. Absent §173, expenditures to establish or increase circulation will probably have to be capitalized under §263. No current deduction, however, is allowed for expenditures incurred for the purchase of land, depreciable property, or the acquisition of circulation through the purchase of any part of the business of another publication.[103]

A taxpayer entitled to the deduction for circulation expenditures under §173 may, in lieu of taking the deduction, elect to capitalize that portion of the circulation expenditures which is properly chargeable to capital account.[104] In general, expenditures normally made from year to year with a view to maintain circulation are not chargeable to capital account. Conversely, expenditures made to establish or increase circulation are properly chargeable to capital account.

Example: If a newspaper normally employs five persons to obtain renewals of subscriptions, the expenses attributable to those employees are not chargeable to capital account. If the newspaper, in a special campaign to increase circulation, however, employs 20 additional persons for a limited time to solicit new subscriptions, these expenditures would be chargeable to capital account.[105]

If a taxpayer makes an election with respect to expenses chargeable to capital account, such election applies to all expenditures which are so chargeable. The election once made, is irrevocable except with the Commissioner's consent. The extent to which an amortization deduction with respect to capitalized expenditures is available will be determined under §§162, 263, and 461.[106]

(b) Definition

For a corporate taxpayer which is a personal holding company, a deduction under §173(a) will give rise to an upward adjustment to AMTI.[107] Section 56(b)(2)(C) provides that circulation expenditures paid or incurred after December 31, 1986, by a personal holding company, which are deductible currently under §173(a) in computing regular taxable income, must be capitalized and amortized ratably over a 3-year period beginning with the year in which such expenditures are incurred in arriving at AMTI.[108] Circulation expenditures deducted under §173(a) will therefore, result in an upward adjustment to AMTI.

Example: If a personal holding company deducts $45,000 under §173 in 1987, its AMTI will be adjusted upward by $30,000 because it is allowed a deduction of only (1/3 x $45,000)=$15,000 for purposes of AMTI. The taxpayer's AMTI, however, will be adjusted downward by $15,000 in each of its taxable years 1988 and 1989, compensating it fully for the $30,000 upward adjustment to AMTI in 1987.

If the taxpayer suffers a loss with respect to circulation expenditures deducted under §173, then, for purposes of computing AMTI, the entire unamortized portion of such expenditures may be deducted in the year of the loss.[109] The amount of this deduction, however, is limited to the amount that would be allowable as a loss deduction under §165(a) if the circulation expenditure had remained capitalized.[110]

Note that, in lieu of deducting circulation expenditures under §173, the taxpayer may elect under §59(e) to capitalize and amortize such expenditures ratably over a 3-year period beginning with the taxable year in which such expenditures are incurred in computing its regular taxable income. If the taxpayer makes an election under §59(e), no adjustment to AMTI will result.

(c) AMT Planning

In lieu of taking a current deduction under §173(a), the taxpayer may elect to capitalize that portion of circulation expenditures which are properly chargeable to capital account.[111] Generally, expenditures incurred to maintain the circulation of a periodical are not chargeable to capital account, whereas expenditures incurred in establishing or increasing circulation are so chargeable. The expenditures thus capitalized may be amortized, provided the taxpayer can demonstrate the limited useful life of the new subscriptions obtained.

Comment: The industry experience indicates that a magazine or a newspaper subscription typically runs for only one year and the average subscriber renews for only two or three years before dropping the subscription. It may, therefore, be possible to amortize the capitalized circulation expenditures over a 3-year period. Support for this position may be found in §59(e)(1) which permits a 3-year amortization of such expenditures.

The taxpayer also has the option of electing under §59(e) to capitalize and amortize ratably over a 3-year period all circulation expenditures. Some relevant considerations bearing upon these options are summarized below:

(i) The §173(a) election applies to only those expenditures which are chargeable to capital account. The §59(e) election, on the other hand, may be made for all expenditures deductible currently under §173(a), including expenditures incurred to maintain circulation.

Comment: Where the amount incurred for increasing circulation during the taxable year is relatively small as compared to the amount expended on maintaining circulation, an election under §173(a) will not help the taxpayer in eliminating the upward adjustment to AMTI. In such a case, an election under §59(e) is indicated if the taxpayer desires to eliminate the adjustment to AMTI.

(ii) If an election under §173(a) is made, it applies to all circulation expenditures properly chargeable to capital account.[112] An election under §59(e), on the other hand, may be made with respect to any portion of circulation

[103] Regs. §1.173-1(a)(1).
[104] Regs. §1.173-1(c)(1).
[105] *Id.*
[106] *Id.*
[107] This adjustment does not apply to a corporation which is not a personal holding company.
[108] §56(b)(2)(A)(i).
[109] §56(b)(2)(B)(ii).
[110] §56(b)(2)(B)(i).
[111] Regs. §1.173-1(c)(i).
[112] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

expenditures including those incurred on maintenance of circulation.[113]

Comment: The §59(e) election provides the taxpayer with a planning tool because it enables the taxpayer to enjoy the best of both worlds, *i.e.*, capitalization under §59(e) to avoid AMT and a current deduction under §173(a) at the same time. For example, the taxpayer may capitalize under §59(e) just enough of the circulation expenditures necessary to avoid AMT and deduct the balance under §173(a).

Before deducting circulation expenditures under §173(a), the taxpayer must assess the impact of such a deduction on its AMT liability. If such impact is negative, it may utilize either an election under §173(a) or §59(e), whichever yields more favorable results.

(7) Gain or Loss Upon Disposition of Certain Assets

As previously discussed, in the case of: (i) depreciation of real or personal property, (ii) amortization of pollution control facilities, (iii) mining development and exploration costs, and (iv) circulation expenditures, allowable deductions are determined for AMTI purposes under rules which are different from the rules that apply for regular tax computations. Since the AMT rules are designed to eliminate the deferral effect of the regular tax rules, AMT deductions are smaller than regular tax deductions, at least in the early years. To take into account this disparity in write-off rules, §56(a)(7) provides that, for purposes of computing AMTI, the adjusted bases of the types of assets described above are determined based upon the amount of deductions permitted for AMTI computations. Consequently, when an asset of the type in question is disposed of, the amount of gain or loss will be different for AMTI purposes than for regular tax purposes.

Example: A, a calendar year taxpayer, places depreciable personal property in service after December 31, 1986, at a cost of $3,000. The property has a recovery period of three years and its ADR life is four years. The following table shows the depreciation deductions that are available for both regular tax purposes and AMTI purposes:

Year	*Type of Tax*	*Adjusted Basis*	*Deduction*
1987	Regular Tax	$3,000	$1,000
	AMT	3,000	563
1988	Regular Tax	2,000	1,334
	AMT	2,437	914
1989	Regular Tax	666	444
	AMT	1,523	609
1990	Regular Tax	222	222
	AMT	914	914
1991	Regular Tax	0	0
	AMT	305	305

Assuming the property is sold by A on January 1, 1989, for $4,000, its gain for regular tax and AMT purposes is computed as follows:

Regular Tax Gain = $4,000 − $666 = $3,334

AMT Gain = $4,000 − $1,523 = $2,477

Thus, in computing its regular taxable income for 1989, A will take into account a gain of $3,334. whereas a gain of $2,477 will enter into its AMTI computations.

(8) Capital Construction Funds for Shipping Companies

(a) General

Under the Merchant Marine Act of 1936, as amended,[114] a taxpayer may enter into an agreement with the Maritime Administration[115] to maintain a Capital Construction Fund (CCF or Fund). Participation in the CCF program enables the owners or lessees of U.S.-flag vessels operating in the foreign or domestic trade of the United States or in U.S. fisheries to essentially establish a government-sanctioned tax shelter which permits them to currently deduct from income deposits into the CCF and also exclude from income those earnings which are from the investment or reinvestment of amounts held in the Fund. If the taxpayer makes a "qualified withdrawal" (*i.e.*, a withdrawal made for the acquisition, construction, or repair of a vessel covered by the CCF Agreement), the taxpayer must reduce its basis in the vessel,[116] but need not recognize any income. If, however, a nonqualified withdrawal is made, the withdrawal is taxed in accordance with ordering rules which treat the withdrawal as being made first out of the ordinary income account of the CCF, then from the capital gain account and finally from the capital account.

The Tax Reform Act of 1986 coordinates the Merchant Marine Act with the Internal Revenue Code for the first time and modifies some of the treatment of certain withdrawals made from the Fund. Qualified withdrawals are expanded under the Act to include the purchase or lease of an agreement vessel for a period of five years or more. With respect to nonqualified withdrawals, the maximum marginal tax rate on individuals and corporations is imposed on such withdrawals made after December 31, 1986. Moreover, a 25-year limit is imposed on the amount of time in which monies may remain in a CCF without being withdrawn for qualified purposes, with such funds being treated as withdrawn 20% in the 26th year, and an additional 20% in each subsequent year until 100% of the funds are deemed withdrawn in a nonqualified withdrawal in the 30th year. The Secretary of Transportation (in the case of U.S.-flag vessels used in the foreign and noncontiguous domestic trade) and the Secretary of Commerce (in the case of U.S. fishing vessels) are required to certify to the Secretary of the Treasury that the amount of funds held in a CCF are appropriate for the vessel construction, reconstruction or acquisition program contemplated in each CCF agreement. If the current funds in the CCF exceed the needs of the taxpayer's program, the fundholder is given three years to develop appropriate program objectives.

[113] §59(e)(4)(A).

[114] 46 U.S.C. §1101 *et seq.*

[115] An agency within the United States Department of Transportation.

[116] *See* 46 U.S.C. §1177(g)(3)and (4).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Failure to do so results in such excess funds being treated as a nonqualified withdrawal.

(b) Definition

In determining AMTI, the nontaxability of deposits and Fund earnings under post-1986 TRA Code §7815 (and the corresponding sections of the Merchant Marine Act §607)[117] do not apply to any amount deposited into the Fund after December 31, 1986, or to any earnings (including gains and losses) on amounts in the Fund after December 31, 1986.[118] Thus, in determining AMTI, amounts deposited in a Fund after 1986 are not deductible and earnings (including gains and losses) of the Fund after 1986 are not excludable.[119] Moreover, no reduction in basis is permitted under Code §7518(f) (or corresponding §607 provision of the Merchant Marine Act) for the withdrawal of such taxable income, gain, or Fund earnings to the extent that such amounts have previously been included in AMTI.[120] Any withdrawal of deposits or earnings from the Fund, however, are to be allocable first to deposits made before January 1, 1987 and earnings received or accrued before that date.[121] This means that amounts deposited in or earned by a Fund before 1987 are treated as withdrawn prior to amounts deposited or earned after 1986.[122]

(9) Special Deduction for Certain Insurance Companies

(a) General

Under changes made by the Tax Reform Act of 1986, Blue Cross and Blue Shield organizations and some other previously tax-exempt insurers lose their tax-exempt status for regular tax purposes. These insurers are, after the TRA, taxable under rules similar to those that apply to life insurance companies. Section 833(b) of the Code permits these previously tax-exempt insurance companies a deduction for a portion of the expenses associated with the resolution of insurance claims.

(b) Definition

Section 56(c)(3) provides that, in computing AMTI, the deduction permitted under §833(b) will be disallowed. Thus, an insurer which claims a deduction under §833(b) for regular tax purposes will have an upward adjustment to its AMTI.

(10) Possessions Corporations

(a) General

If a domestic corporation makes an election under §936(a), it is entitled to a credit against its U.S. income tax liability for the amount of tax that is attributable to the foreign source taxable income derived from the active conduct of a trade or business (including the sale or exchange of substantially all the assets of such trade or business) in Puerto Rico or the Virgin Islands and qualified Puerto Rico or the Virgin Islands source investment income, provided the corporation meets the gross income test of §936(a)(2)(A) and the active business test of §936(a)(2)(B). The corporation meets the gross income test if 80% or more of its gross income for the prior 3-year period is derived from sources within Puerto Rico or the Virgin Islands. It meets the active business test if 75% or more of its gross income for the prior 3-year period is derived from the active conduct of a trade or business in Puerto Rico or the Virgin Islands. The 75% test applies for taxable years beginning in 1987. The percentage was 65% for taxable years beginning in 1985 and 1986, 60% for taxable years beginning in 1984, and 55% for taxable years beginning in 1983.

(b) Definition

Section 59(b) provides that the AMTI of any domestic corporation which elects the benefits of §936 does not include the amount of income with respect to which a credit under §936(a) is available. Thus, a domestic corporation which claims a credit under §936(a) will exclude the following types of income from its AMTI:

(i) income derived from the active conduct of a trade or business in Puerto Rico or the Virgin Islands,

(ii) income derived from the sale or exchange of substantially all the assets used in the conduct of a trade or business in Puerto Rico or the Virgin Islands; and

(iii) qualified investment income derived from sources within Puerto Rico or the Virgin Islands.

The net effect of this adjustment is to prevent any AMT liability arising from the possessions source income with respect to which a credit under §936 is claimed.

(11) Disallowance of Passive Activity Losses

(a) General

Effective generally for years beginning after December 31, 1986, Act §501 enacted Code §469 to limit the "passive activity losses" and credits of certain taxpayers. In general, a "passive activity" is any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. The taxpayers to whom the §469 limits will apply include individuals, estates, trusts, personal service corporations, and (to a lesser extent) other closely held C corporations.

If a loss or credit is derived from a passive activity by one of the foregoing taxpayers (other than closely held C corporations), the loss or credit will be limited to income generated from other passive activities. Any loss or credit not allowed by reason of the §469 limits will be available as a carryforward to future years and will generally be allowed when passive income is generated from the activity or from other passive activities or, in the case of losses, when the activity is sold or otherwise disposed of.

(I) Definition of Passive Activity

Post-TRA Code §469(c) defines a "passive activity" as any activity involving the conduct of any trade or business in which the taxpayer does not materially participate. A passive activity includes any rental activity, regardless of whether it constitutes a trade or business and regardless of the taxpayer's "material participation" in the activity. If

---

[117] Specifically, Code §7518(c)(1)(A), (B), and (C).
[118] Act §701(a), adding Code §7518(c)(2)(A)(i) and (2).
[119] Senate Report at 529.
[120] Code §56(c)(2)(B). *See also* Senate Report at 529.
[121] Code §56(c)(2).
[122] Senate Report at 529.

the rental activity requires the provision of substantial services, however, such as a hotel, the activity is not treated as passive so long as the taxpayer materially participates. For purposes of the passive activity definition, a trade or business will include any activity involving research or experimentation within the meaning of §174 or, to the extent provided in regulations, any activity in connection with a trade or business or any §212 income-producing activity.

Under §469(h), a taxpayer "materially participates" in an activity only if the taxpayer's involvement in the activity is regular, continuous, and substantial. In determining whether a taxpayer materially participates, the activities of a spouse will be attributed to the taxpayer. Moreover, a special rule permits a retired farmer or a surviving spouse of a farmer to be treated as a material participant if, prior to retirement or death, the farmer materially participated in the farming activity. A corporation subject to §469 is treated as materially participating if over 50% (by value) of the shareholders materially participate in the activity or if, in the case of a closely-held C corporation (but not personal services corporation), the business is an active business meeting the requirements of §465(c)(7)(C)(i), (ii) and (iii).

A taxpayer is not treated as materially participating in a limited partnership to the extent of the taxpayer's interest in the partnership as a limited partner. For example, if a taxpayer holds a 25% general partnership interest and a 25% limited partnership interest in the same partnership and the taxpayer materially participates in the partnership's activities, the losses and credits allocable to the 25% limited partnership interest will be treated as passive. To prevent avoidance of the passive loss limits, regulations may override the general rule that a limited partnership interest is treated as passive.

(II) Taxpayers Subject to Passive Limits

Section 469(a)(2) provides that the following taxpayers may be subject to the passive loss and credit limits:

(i) Any individual, estate, or trust,

(ii) Any closely held C corporation, and

(iii) Any personal service corporation.

Section 469(j)(1) defines a "closely held C corporation" as any C corporation where, at any time during the last half of the taxable year, more than 50% in value of the outstanding stock is owned by no more than five individuals (applying the personal holding company attribution rules). A "personal service corporation" is defined as a corporation the principal activity of which is the performance of personal services that are substantially performed by employee-owners. A corporation will not be treated as a personal services corporation, however, unless more than 10% of the stock by value is held by employee-owners.

Under §469(e)(2), the passive loss and credit limits are less restrictively applied to closely held C corporations than to the other categories of taxpayers subject to the limits of §469. Section 469(e)(2)(A) provides that if a closely held C corporation (other than a personal service corporation) has net active income for any taxable year, the passive activity loss of such taxpayer for the taxable year (determined without regard to this paragraph) — (i) shall be allowable as a deduction against net active income, and (ii) shall not be taken into account under §469(a) to the extent so allowable as a deduction. A similar rule applies to any passive activity credit of the taxpayer. Section 469(e)(2)(B) defines "net active income" as the "taxable income of the taxpayer for the taxable year determined without regard to — (i) any income or loss from a passive activity, and (ii) any item of gross income, expense, gain, or loss described in paragraph (1)(A) [relating to portfolio income]." Thus, while closely held C corporations (other than personal service corporations) are not permitted to use passive-activity losses to reduce portfolio income, such losses can be used to offset income from the corporation's active business.

(III) Definition

Although income or loss from each passive activity must be separately accounted for, a taxpayer's passive activity loss for a taxable year is determined by netting the aggregate income and losses from all passive activities. If aggregate losses exceed aggregate income, the resulting net loss is the taxpayer's "passive activity loss." According to the Conference Report,[123] all deductions arising from passive activities, including deductions allowed under §§162, 163, 164, and 165, must be taken into account, even if claimed as an itemized deduction on the taxpayer's return. It is unclear, however, whether a charitable contribution deduction that arises from the contribution of, for example, a facade easement by a limited partnership would be subject to the passive loss rule. Interest deductions attributable to passive activities are treated as passive activity deductions and will not be treated as investment interest subject to the revised investment interest limits of §163(d).

Section 469(d)(2) defines a "passive activity credit" as the amount, if any, by which the sum of various business credits derived from passive activities exceeds the taxpayer's regular tax liability for the taxable year allocable to passive activities. The credits subject to limitation as passive activity credits include:

(i) The §936 possessions credit;

(ii) The orphan drug credit;

(iii) The nonconventional fuels credit; and

(iv) The general business credit which, after 1986, will include the rehabilitation credit, the energy investment credit, the research credit, the alcohol fuels credit, the targeted jobs credit, and the post-TRA low-income housing credit.

Under §469(e), (i) portfolio income (interest, dividends, annuities, royalties, and investment gains), (ii) expenses other than interest that are clearly and directly allocable to portfolio income, and (iii) interest expense properly allocable to portfolio income are not taken into account in determining the income or loss from an activity. For this purpose, however, an interest in the passive activity is not treated as investment property so that gains and losses upon disposition of a passive activity interest will be

[123] Conference Report at II-139.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

taken into account in determining passive activity income and loss. Investment earnings on an activity's working capital will be treated as portfolio income for purposes of the foregoing rule.

Earned income will not be treated as passive income for purposes of the passive limits.

(IV) Exceptions

Section 469(e)(2) permits the passive losses of a closely held C corporation, other than a personal service corporation, to offset all income except portfolio income.

Section 469(i) provides a limited exception for individuals who actively participate in real estate activities. Under this exception, up to $25,000 of passive losses (or the amount of credit that is the deduction equivalent of the passive loss) may be used to offset nonpassive income. This $25,000 amount, however, is phased out if the taxpayer's adjusted gross income (AGI), excluding passive losses, exceeds $100,000. Under the phaseout, for every $2 of AGI above $100,000, the $25,000 amount is reduced by $1. Thus, the exception vanishes if AGI exceeds $150,000.

The $25,000 amount is available generally only if the taxpayer is a "active participant" in the rental activity. A taxpayer will not be treated as an active participant if, at any time during the taxable year, the taxpayer's interest in the activity is less than 10% by value of all interest in the activity. Moreover, a taxpayer's interest as a limited partner will not be treated as an interest with respect to which the taxpayer actively participates.

Two special rules apply to the rehabilitation and low income housing credits. First, the $25,000 amount (in a deduction-equivalent sense) is available regardless of active participation by the taxpayer. Second, the threshold for the phase-out of the $25,000 amount is raised to $200,000.

Section 469(j)(5) defines "deduction equivalent" as the amount of credits which, if allowed as a deduction, would reduce the regular tax liability for the taxable year by an amount equal to such credits. Assuming a taxpayer's taxable income is entirely subject to tax at the 28% rate and the taxpayer has no itemized deductions dependent upon the amount of the taxpayer's AGI, the deduction equivalent of credits equal to the $25,000 amount is $7,000.

(V) Suspended Passive Losses and Credits

Losses and credits not allowed under §469 are suspended until the taxpayer generates passive income from the passive activity or has income from unrelated passive activities. Under §469(g), if a taxpayer disposes of his entire interest in any passive activity in a fully taxable transaction, any suspended loss as well as any loss arising in the year of disposition will be allowable as follows:

(i) First, against income or gain from the passive activity for the taxable year including any gain recognized on the disposition;

(ii) Second, against net income or gain for the taxable year from other passive activities; and

(iii) Finally, against all other income or gain.

A capital loss from the disposition of the passive activity will, however, be subject to the §1211 capital loss limitations. Moreover, losses will continue to be suspended if the taxpayer transfers the interest to a related person. If the interest is sold in an installment sale, a ratable share of the suspended losses will be allowed each year in accordance with the amount of the installment sale gain reported for that year for regular tax purposes.

If a taxpayer dies, suspended losses will be allowed on the taxpayer's final return to the extent that the losses exceed the step-up in basis (to fair market value) that occurs under §1014 upon death.

Under §469(j)(6), if an interest in a passive activity is transferred by gift, the basis of the interest will be increased by the amount of the suspended losses and such losses will no longer be allowable as a deduction for any taxable year.

Section 469(j)(9) provides an election upon disposition of a passive interest under which a taxpayer may increase his basis in the passive activity by the amount of any unused credit which reduced basis of the property for the taxable year in which the credit arose. The basis increase is made as of the time immediately before the transfer. If this election is made, the passive activity credit will not be allowed in the future. If the election is not made and if the transfer does not otherwise cause recapture of the credit, the suspended credit will be allowed to offset the regular tax from the gain, if any, generated on the transfer or to offset the regular tax from passive income subsequently generated from other activities.

Under §469(f), if an activity ceases to be a passive activity, suspended passive losses and credits will be allowed as an offset against future income and future regular tax liability from active operations. Otherwise, the suspended deductions and credits continue to be treated as arising from a passive activity. Similar principles apply to a change in status of a closely held C corporation or personal service corporation.

(VI) Effective Dates and Phase-In Rules

The passive loss limits apply generally to taxable years beginning after December 31, 1986. Loss and credit carryovers from a taxable year beginning before 1987 and carried to a taxable year beginning after 1986, however, are not subject to the limits. Special transition rules apply to low-income housing. *See* Act §§501(c)(3) and §502.

Under §469(1), the passive loss limits are phased-in over four years if (i) the taxpayer held the interest in the passive activity, or was under a binding contract to acquire the interest in the passive activity, on the date of enactment of the 1986 TRA and at all times thereafter, and (ii) the passive activity was being conducted on date of enactment or the property used in the activity was acquired pursuant to a binding written contract in effect on August 16, 1986, or construction of the property began on or before August 16, 1986. Under the phase-in, 65% of a passive activity loss and credit is allowed for taxable years beginning in 1987. This is reduced to 40% in 1988, 20% in 1989, and 10% in 1990.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(b) Definition

One rationale for the enactment of passive loss rules of §469 is that a loss in the current year does not necessarily reflect a true economic loss, especially if it derives from an activity with future income potential. The loss can be determined with accuracy only when the activity is finally disposed of.

The deferral that is prohibited by §469 for regular tax purposes is also prohibited by §58(b) for AMT purposes. Section 58(b) provides that, for purposes of computing AMTI, passive activity losses will be suspended. In determining the amount of loss that must be suspended in computing AMTI, the rules of §469 apply with four modifications:

(i) The adjustments of §56 are taken into account. Thus, for example, a taxpayer placing residential rental real estate in service in 1987 will compute its depreciation deduction for regular tax purposes by using a recovery period of 27.5 years. For purposes of computing AMTI, however, the taxpayer must use a recovery period of 40 years. Assuming the rental activity generates a loss in 1987, the passive loss that must be suspended under §469 is determined by taking into account the depreciation deduction computed over a useful life of 27.5 years, whereas a useful life of 40 years is used in determining the depreciation deduction that enters into the computation of the passive loss that must be suspended under §58(b). The amount of loss disallowed for AMT purposes, therefore, will be smaller than the loss disallowed for regular tax purposes because of the smaller depreciation deduction.

(ii) Any deduction that is an item of tax preference under §57 shall not be taken into account. Thus, for example, if the taxpayer's passive activity loss computed under §469 includes a percentage depletion deduction, such deduction will be disregarded in computing passive activity loss under §58(b). The rationale for this is that the depletion deduction is restored to AMTI under §57(a)(1) and disallowing it again under §58(b) as part of the passive activity loss would amount to double counting.

(iii) The phase-in rules of §469(l) do not apply for purposes of computing a passive activity loss that is disallowed under §58(b). This rule will produce serious AMT consequences to taxpayers which utilize the phase-in rules for regular tax purposes.

(iv) If a taxpayer is insolvent, the amount of passive activity loss that is disallowed under §58(b) in computing its AMTI is reduced by the amount by which taxpayer is insolvent as of the close of the taxable year.[124] The amount by which a taxpayer is insolvent is the excess of its liabilities over the fair market value of its assets.[125]

In summary, the amount of passive loss that is disallowed in determining AMTI is computed after taking into account all adjustment and preference items described in §§56-58.

[124] §58(c)(1)(A).
[125] §58(c)(1)(B).

(12) Book Income/Adjusted Current Earnings [126]

(a) Background

The corporation that reports substantial profits to its shareholders and yet pays no federal income taxes is a phenomenon that has received considerable publicity in recent years, and considerable attention from proponents of tax reform. Theoretically, there should be little disparity between income for financial accounting purposes and income for tax purposes as long as the income tax base is reasonably comprehensive and deductions are limited to those required to accurately measure net income. In recent years, however, the regular federal income tax system has fallen far short of satisfying these two conditions, and the supplementary minimum tax system has not come that much closer. The Tax Reform Act of 1986 [127] represents probably Congress' most determined effort ever to bring the federal income tax base closer to economic income. In particular, the revised minimum tax rules, eliminating for minimum tax purposes the incentive effect of the bulk of preferences still allowed for regular tax purposes, go a long way toward achieving the reformers' goal of compelling economically profitable corporations to pay some income tax, even without regard to the adjustments to be considered in this section.

Nevertheless, when the Senate was considering the 1986 Act, there was concern, despite the prospect of a substantially toughened minimum tax, that some profitable corporations would continue to escape tax liability.[128] Congress decided to attack the problem directly by requiring all corporations to pay a tax, at minimum tax rates, on at least 50% of their reported profits. This was to be done by requiring corporations to add into their AMTI an amount equal to 50% of the excess, if any, of reported profits over AMTI without regard to any reported profits adjustment.

The decision of the Senate to adopt this reported profits or book income adjustment for alternative minimum tax purposes evoked strong criticism from business and accounting groups. The chief complaint was that the tax disadvantage attached by the Senate bill to the reporting of profits for financial accounting purposes would create an undesirable tension between the tax and financial accounting rules. Managers and accountants would be torn between the desire to report profits and the desire to minimize taxes. To the extent they chose to sacrifice the former objective to the latter, it was argued, the accounting profession would come under pressure to adopt rules tending to understate economic income, with a resulting decline in the reliability of financial information. In addition, the Service would be put in the position of having to police financial accounting practices—a task that could be accomplished, if at all, only with great difficulty and at enormous cost.

The Conference Committee did not turn a deaf ear to these criticisms, but neither did it find them so persuasive that it was willing to give up the book income adjustment altogether. What emerged from the Conference Committee

[126] This section was prepared by Donald J. Mathison, Esq., Silverstein and Mullens, Washington, D.C.
[127] P. L. 99-514.
[128] *See* Senate Report at 520.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

and was enacted into law — as an apparent result of a political compromise — was a two-stage system under which the Senate's book income adjustment was preserved more or less intact for 1987, 1988, and 1989, and then is replaced in 1990 and subsequent years with an adjustment based on current earnings.[129]

Disinterested observers may be struck by the oddness of inserting into the tax law a concept as radical as the book income adjustment and providing for its expiration after a period of only three years. Some have attributed this unusual procedure to Congress' urgent need for revenue in 1987, 1988, and 1989. It is also noteworthy that the Conference Committee directed the Treasury Department to study the book income and earnings and profits provisions of the Act and report back to Congress by January 1, 1989.[130] Conceivably, a favorable report by Treasury concerning the book income adjustment could prompt Congress to extend its life and forestall its replacement with the less controversial earnings and profits adjustment.

This section will consider the two adjustments, that for book income and that based on earnings and profits.

(b) Book Income (1987, 1988, and 1989)

(I) General Rule

Consistent with the Senate bill, the Act provides that, for taxable years beginning in 1987, 1988, or 1989, a corporation must increase its AMTI by 50% of the amount (if any) by which its "adjusted net book income" (ANBI) for the year exceeds its AMTI for the year, determined without regard to the ANBI adjustment and also without regard to the alternative tax net operating loss deduction.[131] The Act provides that "ANBI" generally means "the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement," with certain adjustments.[132] "Applicable financial statement" is another defined term. The extensive definition of this term, to be discussed below, contains the most critical elements of the ANBI concept. At this point, however, it bears repeating that the practical effect of the ANBI adjustment is that any corporation with financial statement income in 1987, 1988, or 1989 will be required to pay a tax of no less than 10% of such income (20%, the AMTI rate, of the 50% of financial statement income that must be included in AMTI).

The Senate Report provides additional information not set forth in the statute concerning the mechanics of the book income adjustment.[133] A corporation may have negative amounts of either or both ANBI and AMTI. A positive amount exceeds any negative amount, and a smaller negative amount exceeds any larger negative amount. Thus, in an example given in the report, if a corporation has ANBI of $100 and AMTI (without regard to the ANBI adjustment) of negative $50, there will be a positive ANBI adjustment of $75—50% of the $150 excess of ANBI over AMTI. As a result, the corporation has AMTI of $25.

The financial statement income that Congress sought to tax by means of the ANBI adjustment is pre-tax income. Therefore, the Act provides that ANBI must be adjusted to disregard any federal or foreign income taxes that are directly or indirectly taken into account on a corporation's applicable financial statement.[134] The one exception to this rule is for foreign taxes that a corporation elects to deduct rather than to credit pursuant to Code §901. Note that it is not only separately stated Federal or foreign income taxes that must be disregarded, but also those "indirectly" taken into account. The legislative history makes it clear that a corporation cannot mitigate the consequences of the ANBI adjustment by including (that is, hiding) federal or foreign income taxes in other items of income or expense.[135]

Some corporations have taxable years that are different from their financial accounting years. "Appropriate adjustments" are to be made where the taxable year and the financial accounting year do not coincide.[136] Generally a corporation will be required to include in its AMTI for a taxable year a pro rata portion of the ANBI in each financial accounting year with which that taxable year overlaps.[137]

(II) Definition of Applicable Financial Statement

The term "applicable financial statement" (AFS) is given an elaborate definition.[138] A corporation is intended to have a single AFS for each taxable year. Many kinds of financial reports are eligible to constitute an AFS, but the Act establishes a hierarchy, so that, if a corporation has more than one kind of eligible report for a given year, as will often be the case, only one will be its AFS and the corporation will not be able to choose which report to use in computing its AMT liability.[139]

To be an AFS, a report must be some kind of financial statement. A financial statement is generally expected to include an income statement, a balance sheet, a statement of assets, liabilities, and owners' equity, a statement of changes in owners' equity, and other appropriate information.[140] An income statement alone, however, may constitute a taxpayer's AFS if the taxpayer does not prepare a balance sheet and other customary documents. An income statement will not establish income for AMT purposes, however, unless it reconciles with such other financial documents as the taxpayer does prepare.

At the top of the hierarchy is a statement filed with the Securities and Exchange Commission.[141] Such a statement is treated as a taxpayer's AFS before any of the other eligible kinds of reports.

Next in priority is a certified audited income statement used for credit purposes in a report to shareholders, or for any other substantial nontax purpose.[142] According to the

[129] §56(c)(1).
[130] Conference Report at II-278-79.
[131] §56(f)(1).
[132] §56(f)(2)(A).
[133] Senate Report at 534-35.
[134] §56(f)(2)(B).
[135] Senate Report at 533.
[136] §56(f)(2)(B).
[137] Senate Report at 533.
[138] §56(f)(3).
[139] §56(f)(3)(C).
[140] Senate Report at 530.
[141] §56(f)(3)(A)(i).
[142] §56(f)(3)(A)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

legislative history, a financial statement is considered to be certified if it is accompanied by an opinion of a professional accountant stating that it is generally consistent with the taxpayer's accounting principles.[143] If a corporation has more than one certified audited statement, a statement that is used for credit purposes takes precedence over all others, and a statement that is used in a report to shareholders takes precedence over a statement used for some other substantial nontax purpose.[144]

Third in priority is an income statement required to be provided to the federal government or any agency thereof, a state government or any agency thereof, or a political subdivision of a state or any agency thereof.[145] As in the case of certified audited income statements, there is an order of precedence within this category, so that a statement required to be made to the federal government or an agency thereof has priority over a statement required to be made to a state or an agency thereof, and a statement required to be made to a state or an agency thereof has priority over a statement required to be made to a political subdivision of a state or an agency thereof.[146]

Lastly, if a taxpayer has no financial report falling in any of the first three categories of AFSs, any income statement used for credit purposes, in a report to shareholders, or for any other substantial nontax purpose may constitute its AFS.[147] There is the same ranking of different kinds of statements within this category as in the case of certified audited income statements.[148] In applying this and all the rules of priority, only statements that are actually used by the taxpayer are given consideration.[149]

The question arises to what constitutes a corporation's AFS where it has more than one statement having precisely the same priority. The answer that may be inferred from the legislative history is that the latest in time will prevail.[150] Adjustments to financial statements made after the statements are issued, however, will not retroactively affect ANBI unless the original statements are actually restated.[151]

The further question arises as to what constitutes a corporation's AFS where it has no statement at all in any of the four categories. The Senate Report indicates the Committee's view that this will seldom be the case.[152] Noting that taxpayers are required to maintain books and records, the report states that a summarization of these books and records, where possible, may be used as a corporation's AFS. If a corporation has no books and records capable of summarization, however, financial statement net income or loss, for purposes of determining ANBI, will be treated as being equal to its subchapter C earnings and profits.[153]

In addition, a corporation having an AFS in the category having the lowest priority—namely, an unaudited income statement used for credit purposes, in a report to shareholders, or for another substantial nontax purposes—may elect to treat subchapter C earnings and profits as its financial statement net income or loss.[154] Whenever a taxpayer makes this election, the election will remain in effect as long as the taxpayer continues to be eligible to make it unless the Service consents to a revocation.

(III) Corporations with Affiliates

Many corporations consolidate with affiliated corporations for tax purposes, financial reporting purposes, or both. Different principles, however, govern tax and financial reporting consolidation.

ANBI, as the legislative history makes clear, is to be determined on a consolidated basis, for all the corporations included on one consolidated return and no others.[155] Given this rule and the disparity between tax and financial reporting consolidation principles, the AFS's of some corporations with affiliates will reflect the results of affiliate operations that should not be taken into account for tax purposes, while the AFS's of other corporations with affiliates will fail to reflect the results of affiliate operations that should be taken into account for tax purposes. Rules must be provided to appropriately adjust AFS net income or loss in light of this fact, and the Act recognizes this need.

The Act provides that, when a corporation files a consolidated return, its ANBI shall take into account items on its AFS that are allocable to members of its affiliated group included on the consolidated return.[156] Conversely, where an affiliated corporation is not included on a taxpayer's consolidated return, ANBI will take into account the earnings or loss of the affiliate only to the extent of dividends actually paid to the taxpayer and other amounts required to be included in the gross income of the taxpayer in respect of the affiliate's earnings[157] (for example, subpart F income of a controlled foreign corporation).

These somewhat sketchy statutory instructions are elaborated upon in the Senate Report. Summarizing the procedures to be followed to produce the proper ANBI for corporations with affiliates, the report states:

> It is anticipated that this adjustment will be accomplished by removing the net income and any related consolidating eliminations of companies that are included for financial statement purposes but not for Federal income tax purposes, and by adding in the net income and related consolidating eliminations of companies that are excluded for financial statement purposes but included for Federal income tax purposes.[158]

Although the concept, so explained, seems simple enough, it remains to be seen how simple it will be to apply in practice.

[143] Senate Report at 530.
[144] §56(f)(3)(A)(ii), 56(f)(3)(*c*).
[145] §56(f)(3)(A)(iii).
[146] *Id.*, §56(f)(3)(C).
[147] §56(f)(3)(A)(iv).
[148] *Id.*, §56(f)(3)(C).
[149] Senate Report at 531.
[150] *Id.* at 531-32.
[151] *Id.*
[152] *Id.* at 531.
[153] §56(f)(3)(B)(i).
[154] §56(f)(3)(B)(ii).
[155] Senate Report at 532.
[156] §56(f)(2)(C)(i).
[157] §56(f)(2)(C)(ii).
[158] Senate Report at 532.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(IV) Special Kinds of Corporations

The Act and its legislative history set forth special rules for determining ANBI in the case of certain special kinds of corporations.

(i) Possessions Corporations

Where a taxpayer receives dividends from a §936 corporation, those dividends are augmented or grossed up, for purposes of measuring the taxpayer's ANBI, by the amount of any withholding taxes paid with respect to the dividends.[159] Any such withholding taxes are then treated as creditable foreign taxes for AMT purposes, but only to the extent the dividends with respect to which they are paid cause an increase in the taxpayer's AMTI.[160] The Conference Report provides two examples of the workings of this provision.[161]

In the first of these examples, a taxpayer receives a $90 dividend from a possessions corporation with respect to which the latter pays $10 in withholding tax. In this case, the dividend is treated as yielding $100 ANBI to the taxpayer (the possessions corporation cannot, of course, consolidate with the taxpayer for tax purposes, so only so much of its earnings as are actually or constructively distributed to the taxpayer are included in its ANBI). On the assumption that this dividend inclusion causes the AMTI of the taxpayer to be increased by $50—which will be the case if ANBI equals or exceeds AMTI without regard to the dividend inclusion, so that the grossed-up dividend increases AMTI by 50% of every dollar thereof—the taxpayer is then entitled to an additional AMT foreign tax credit of $5 (50% of the $10 of withholding taxes).

In the second example, the same dividend and the same withholding tax are assumed, but ANBI is assumed to be $20 less than AMTI without regard to the dividend inclusion. The amount of the dividend inclusion, $100, is not changed. Because, however, the dividend inclusion increases AMTI by only $40—50% of the $80 excess of ANBI over other AMTI—only 40% of the $100 dividend has the effect of increasing AMTI. Therefore, the taxpayer is entitled to only $4 of AMT foreign tax credit for the $10 of withholding tax.

(ii) Alaska Native Corporations

The Alaska Native Claims Settlement Act permits certain Alaska native corporations to use special asset bases in determining cost recovery and depletion deductions.[162] The ANBI of such corporations is to be adjusted to reflect cost recovery and depletion deductions predicated upon those special asset bases.[163]

The Alaska Native Claims Settlement Act also provides favorable timing rules for the deduction of certain expenses.[164] For ANBI purposes, such expenses will reduce ANBI in the same taxable year in which they are deductible for regular tax purposes.[165]

(iii) Cooperatives

In an addition to the ANBI rules as they emerged from the Senate, the Act provides that the ANBI of cooperatives subject to §1381 will not include patronage dividends and per-unit retain allocations deductible under §1382(b) even though such amounts may not be netted out on a given AFS.[166]

(iv) Insurance Companies

Although there is nothing actually in the Act concerning the determination of the ANBI of insurance companies, the Conference Report expresses the conferees' intent that, where the AFS of an insurance company is a statement prepared for regulatory purposes, ANBI will not include dividends to policyholders.[167]

(v) S Corporations, RICs, REITs, and REMICs

The book income adjustment does not apply to S corporations, regulated investment companies, real estate investment trusts, and real estate mortgage investment conduits.[168]

(V) Regulatory Authority to Make Adjustments

The Act grants broad authority to Treasury to issue regulations requiring the adjustment of ANBI "to prevent the omission or duplication of any item."[169] The Senate Report contains several paragraphs of discussion of this grant of authority, listing certain practices that might frustrate the purpose of the book income adjustment which Treasury might need its regulatory authority to suppress.[170] Among these practices are reporting profit or expense items directly to asset, liability, or equity accounts, restating prior year financial statements rather than making adjustments to financial statements for the current year, and claiming depreciation deductions in excess of basis and charging such excess depreciation to a contra-asset account.

Despite the breadth of the grant of authority, the report disclaims any intent to interfere generally in taxpayers' choice of accounting methods or to establish Treasury as the arbiter of acceptable accounting principles. It notes that taxpayers that compute income for financial reporting purposes according to tax accounting rules will not be subject to challenge.[171]

(c) Adjusted Current Earnings (Post-1989 Years)

(I) General Rule

Beginning in 1990, the ANBI adjustment will be replaced by an adjustment based on subchapter C earnings and profits.[172] The thrust of this replacement adjustment is that corporations will be required to pay tax on their economic profits for any taxable year, at the AMT rate, in an amount that is not less than 75% of their pre-tax earnings and profits for that year. The introduction of the earnings and profits adjustment in 1990, as noted, repre-

[159] §56(f)(2)(F)(i).
[160] §56(f)(2)(F)(ii).
[161] Conference Report at II-273.
[162] 43 U.S.C. 1620(c).
[163] §56(f)(2)(G)(i).
[164] 43 U.S.C. 1606(i), (j).
[165] §56(f)(2)(G)(ii).
[166] §56(f)(2)(E).
[167] Conference Report at II-273.
[168] §56(f)(4).
[169] §56(f)(2)(H).
[170] Senate Report at 534.
[171] *Id.*
[172] §56(c)(1)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

sents a concession by the Conference Committee to those business and accounting groups that opposed the book income adjustment adopted by the Senate, so the relative burdensomeness of the two different adjustments can be easily imagined.

To implement the earnings and profits adjustment, the Act coins the term "adjusted current earnings" (ACE). For any taxable year beginning after 1989, a corporation's AMTI is to be increased by 75% of the excess of its ACE over its AMTI determined without regard to ACE and also without regard to the alternative tax net operating loss deduction.[173] At the same time, for any taxable year beginning after 1989, a corporation's AMTI is to be reduced by 75% of any excess of the latter amount over the former.[174] Any reductions of AMTI under this provision, however, are limited to the net amount by which AMTI has been increased as a result of the ACE adjustment (taking into account both increases and reductions) in all prior taxable years.[175]

In making these calculations, negative amounts, whether of ACE or AMTI without regard to ACE, are to be taken into account no less than positive amounts.[176] The Conference Report—essentially the only legislative history that exists for the ACE adjustment—provides helpful examples.[177]

The definition of ACE is of central importance. Curiously, this term is defined by reference to the very term the meaning of which it modifies—AMTI. A corporation's ACE for a taxable year is its AMTI for that year without regard to the ACE adjustment (a necessary qualification to keep the definition from being circular), also without regard to the alternative tax net operating loss deduction, and with certain adjustments.[178] Of course, when ACE is so defined, it is the adjustments that are the vital part of the definition, and it is by means of these adjustments that Congress made the term in large part (but not completely) coextensive with subchapter C earnings and profits. These adjustments will now be examined.

(II) Exclusion Items

Perhaps the most significant adjustment is that for "exclusion items." Whenever an item is excluded from gross income for purposes of determining AMTI but is included for purposes of computing earnings and profits, that item must be included in ACE.[179] At the same time, the amount of an exclusion item included in ACE is reduced by any deduction allocable to that item that would have been allowable in computing AMTI if the exclusion item were includible in AMTI gross income.[180] The term "earnings and profits," as used in this context and in all ACE provisions, means earnings and profits as computed for purposes of subchapter C.[181]

The legislative history gives as an example of the application of these provisions to interest on tax-exempt bonds.[182] This interest is not includible in AMTI, yet it does enter into the computation of subchapter C earnings and profits. Hence, it must be included in ACE. At the same time, any costs incurred in carrying tax-exempt bonds, to the extent they would be allowable as deductions in computing AMTI if the interest from the bonds were includible in AMTI gross income, will be allowed as an offset against ACE.

If income items entering into the determination of earnings and profits but not of AMTI are included in ACE—if, that is, the underlying purpose is to conform ACE to earnings and profits—it would appear to follow that deduction items entering into the determination of AMTI but not of earnings and profits should not reduce ACE, and the Act contains such a rule. A deduction not allowed for earnings and profits purposes is also not allowed for ACE purposes.[183]

The legislative history makes it clear that this provision ordinarily precludes a dividends-received deduction in computing ACE.[184] The statute does, however, contain an exception for certain deductions allowed under Code §§243 and 245 for dividends qualifying for a 100% dividends-received deduction. Under this exception, if a corporation paying and a corporation receiving such a dividend cannot be members of the same affiliated group under §1504 by reason of §1504(b) (that is, because one of them is not an "includible corporation"), then the deduction will be allowed for ACE purposes to the extent the payor corporation is subject to federal income tax.[185] The legislative history presents an example of how this provision might apply to a foreign sales corporation.[186]

Note that, while items not deductible for earnings and profits purposes are also not deductible for ACE purposes, items that are deductible for earnings and profits purposes are not therefore deductible for ACE purposes. In this respect, the computation of ACE does not follow that of earnings and profits. Thus, while earnings and profits are reduced for federal and foreign income tax expense, such expense does not, as the legislative history makes clear, reduce ACE.[187] Neither is there any reduction of ACE for distributions to shareholders.[188]

(III) Depreciation and Depletion

(i) Depreciation

Depreciation deductions are the subject of another important ACE adjustment.[189] There are different adjustments for different classes of assets. The depreciation method to be used for ACE purposes depends in large part upon when the asset was placed in service. Separate methods may be required for (1) assets placed in service in taxable years beginning after 1989; (2) assets placed in

[173] §56(g)(1).
[174] §56(g)(2)(A).
[175] §56(g)(2)(B).
[176] Conference Report at II-274.
[177] *Id.*, at II-274.
[178] §56(g)(3).
[179] §56(g)(4)(B)(i)(I).
[180] §56(g)(4)(B)(i)(II).
[181] §56(g)(5)(B).
[182] Conference Report at II-275.
[183] §56(g)(4)(C)(i).
[184] Conference Report at II-275.
[185] §56(g)(4)(C)(ii).
[186] Conference Report at II-275-76.
[187] Conference Report at II-276.
[188] *Id.*
[189] §56(g)(4)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

service in taxable years beginning before 1990 and subject to the modified accelerated cost recovery system (ACRS) introduced by the Act (generally, assets placed in service in taxable years after 1986 and before 1990); (3) assets placed in service in taxable years beginning before 1990 and subject to the original ACRS (generally, assets placed in service in taxable years after 1980 and before 1987); and (4) all other property (generally, property placed in service before 1981).

For each of these different classes of assets, the Act requires taxpayers to compare the depreciation deductions to which they would be entitled under a statutorily specified method of depreciation with the deductions to which they would be entitled under the depreciation method used for book purposes, and to use for ACE purposes whichever of those two methods yields deductions with a smaller present value.[190]

For the first category of assets, assets placed in service after 1989, the statutorily specified method is the alternative ACRS method of Code §168(g)—that is, straight-line over the ADR midpoint life.[191] For the second category, pre-1990 assets subject to the modified ACRS, the statutorily specified method is straight-line over the remaining ADR midpoint life property as of the beginning of the first taxable year beginning after 1989, using the adjusted minimum tax basis of the asset as of the close of the last taxable year beginning before January 1, 1990.[192] For the third category, pre-1990 assets subject to the original ACRS, the statutorily specified method is straight-line over the remaining ADR midpoint life as of the beginning of the first taxable year beginning after 1989, but using the adjusted regular tax basis of the asset as of the close of the last taxable year beginning before January 1, 1990.[193] For the fourth category, the statutorily specified method is whatever method is used for regular tax purposes.[194]

Significantly, the statutorily specified method for assets in each of the first three categories will, in most if not all cases, be the method used for purposes of computing earnings and profits.

In making the required comparison between the deductions yielded under the statutorily specified method and a taxpayer's method for book purposes, present value is to be determined, under regulations prescribed by Treasury, as of the later of the time the property is placed in service or the beginning of the taxpayer's first taxable year that commences after 1989.[195] In the period prior to the promulgation of regulations, the Conference Report states that, in making the present value determination, taxpayers should use as their discount rate the applicable federal rate under §1274(d).[196] The depreciation method used for book purposes by a taxpayer, or the method of accounting for any other item used for book purposes, is defined as the method of accounting for that item used by the taxpayer on its AFS as determined under the ANBI provisions.[197]

(ii) Depletion

There is also an ACE adjustment for depletion similar to that for depreciation. In the case of any property placed in service in a taxable year beginning after 1989, taxpayers are required to use as a depletion method for ACE purposes either the cost method determined under Code §611 or the method used for book purposes, whichever yields deductions with the smaller present value (determined in the same way as in the case of depreciation deductions).[198]

(IV) Section 312(n) Adjustments

Congress' intent to cause ACE to conform to subchapter C earnings and profits is further seen in the provision [199] that makes most of the earnings and profits computation rules of §312(n) applicable in determining ACE. These rules generally only apply, however, prospectively from the time the ACE adjustment is to replace the ANBI adjustment. Specifically, the Act contains the following limits on the application of the §312(n) rules:

(i) Paragraphs (1), (2), and (3) of §312(n)—relating to construction period carrying charges, intangible drilling costs and mineral exploration development costs, and certain amortization provisions, respectively—apply only to amounts paid or incurred in taxable years beginning after December 31, 1989.[200]

(ii) Paragraph (4)—relating to LIFO inventory adjustments—applies only to taxable years beginning after December 31, 1989.[201]

(iii) Paragraph (5)—relating to installment sales—applies only to installment sales in taxable years beginning after December 31, 1989.[202]

(iv) Paragraph (6)—relating to the completed contract method of accounting—applies to contracts entered into on or after March 1, 1986.[203]

(v) Paragraphs (7) and (8)—relating to redemptions and foreign corporations—do not apply at all.[204]

Consistent with the ACE depreciation and depletion rules, a taxpayer paying or incurring intangible drilling costs or mineral exploration and development costs in taxable years beginning after December 31, 1989, must use the method of deducting those costs that it uses for book purposes if that method yields deductions having a smaller present value (determined as in the case of depreciation and depletion deductions) than the method prescribed by §312(n)(2).[205]

(V) Other Adjustments

The Act prescribes various other ACE adjustments of more limited application.

[190] §56(g)(4)(A)(i), 56(g)(4)(A)(v).
[191] §56(g)(4)(A)(i).
[192] §56(g)(4)(A)(ii).
[193] §56(g)(4)(A)(iii).
[194] §56(g)(4)(A)(iv).
[195] §56(g)(5)(C).
[196] Conference Report at II-276.
[197] §56(g)(5)(A).
[198] §56(g)(4)(G).
[199] §56(g)(4)(D)(i).
[200] §56(g)(4)(D)(i)(I).
[201] §56(g)(4)(D)(i)(II).
[202] §56(g)(4)(D)(i)(III).
[203] §56(g)(4)(D)(i)(IV).
[204] §56(g)(4)(D)(i)(V).
[205] §56(g)(4)(D)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(i) Life Insurance Contracts and Annuity Contracts

The income on any life insurance contract, as determined under §7702(g) for any taxable year, is included in ACE,[206] and a deduction is allowed for so much of any premium as is attributable to insurance coverage.[207] Similarly, income on an annuity contract, as determined under §72(u)(2), is included in ACE.[208]

(ii) Possessions Corporation Dividends

Dividends received from §936 corporations are to be grossed-up by the amount of any withholding tax paid by the §936 corporation in determining the ACE of the recipient, and an increased AMT foreign tax credit will be allowed the recipient, under rules similar to those applicable in computing the ANBI adjustment and the pre-1990 AMT foreign tax credit.[209]

(iii) Exchange of Debt Pools

When a taxpayer realizes a loss on the exchange of one pool of debt obligations for another such pool, and when the obligations in the second pool have substantially the same effective interest rates and maturities as those in the first, the loss is not recognized for ACE purposes.[210]

(iv) Life Insurance Companies

The acquisition expenses of life insurance companies are to be capitalized and amortized, for ACE purposes, in accordance with the treatment required under generally accepted accounting principles, with amortization to take place as if this rule applied to all taxable years.[211] The legislative history elaborates somewhat upon this adjustment, stating that the amortization method to be used is that required by the Financial Accounting Standards Board at the time the costs in question are incurred or, if there is no such required method at that time, a method that is acceptable under guidelines issued by the American Institute of Certified Public Accountants concerning generally accepted accounting principles.[212] The legislative history also makes it clear that expenses of pre-1990 acquisitions will be treated on a fresh-start basis—that is, under the assumption that such expenses have been treated in prior years in the same manner as required under the rule.

The acquisition expense rule does not apply, the Conference Report states (perhaps unnecessarily), to acquisitions of property and casualty insurance companies.[213]

The Conference Report also states that the small life insurance company deduction under §806 does not apply in computing ACE. Neither is the election that small property and casualty insurance companies can make to be taxed only on investment income under §831(b).[214]

(v) Ownership Changes

Whenever a corporation experiences an ownership change within the meaning of §382 after the 1986 TRA's enactment date, and the aggregate adjusted basis of the corporation's assets exceeds the net fair market value of the corporation's stock, the adjusted basis of each individual asset, for purposes of computing ACE, will be limited to its proportionate share of the value of the stock.[215]

(vi) Special Types of Corporations

Like the ANBI adjustment, the ACE adjustment is wholly inapplicable to S corporations, regulated investment companies, real estate investment trusts, or real estate mortgage investment conduits.[216]

(13) Alternative Tax Net Operating Loss Deduction

(a) General

The final adjustment required in the AMTI computations is the substitution of alternative tax net operating loss deduction for the regular tax net operating loss deduction.[217] A taxpayer is required to make two parallel but distinct sets of net operating loss computations: (i) a regular tax net operating loss computation to be used in computing taxpayer's regular tax liability, and (ii) an alternative tax net operating loss computation to be used in computing taxpayer's AMT liability.

(b) Definition

The alternative tax net operating loss deduction is computed the same way as the regular tax NOL deduction but with two essential differences:

(i) the amount of net operating loss (within the meanings of §172(c)) for the loss year is computed: (a) by adjusting the taxable income as provided in §§56 and 58, and (b) reducing the amount of loss by the sum of items of tax preference enumerated in §57 (except the preference for charitable contributions of appreciated property),[218] and

(ii) the deduction is limited to an amount which is 90% of AMTI for the taxable year in which net operating loss deduction is claimed.[219]

Example: Corporation X, a calendar year taxpayer has $100,000 of gross income for 1987 and deductions of $150,000. The deductions include $20,000 depreciation on depreciable personal property placed in service in 1987 and a depletion deduction of $10,000. Corporation X's NOL for regular tax purposes is therefore $50,000. Assuming X's depreciation deduction for purposes of computing AMTI is $12,000, the depreciation adjustment to AMTI equals $8,000. Also, assuming the adjusted basis of the depletable property is $7,000, it gives rise to a depletion preference of $3,000. Corporation X's alternative minimum tax NOL for 1987, therefore, is $50,000 - $8,000 - $3,000 = $39,000.

[206] §56(g)(4)(B)(ii)(I).
[207] §56(g)(4)(B)(ii)(II).
[208] §56(g)(4)(B)(iii).
[209] §56(g)(4)(C)(iii).
[210] §56(g)(4)(E).
[211] §56(g)(4)(F).
[212] Conference Report at II-277.
[213] *Id.*
[214] *Id.*
[215] §56(g)(4)(H).
[216] §56(g)(6).
[217] §56(a)(4).
[218] §§56(d)(1)(B)(i) and 56(d)(2)(A).
[219] §56(d)(1)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The modifications required to convert the regular tax net operating loss deduction into the alternative tax net operating loss deduction are basically designed to take into account the differences between the regular tax base and the AMT base.

The 90% limit is designed to ensure that the NOL deduction does not wipe out a taxpayer's entire AMT liability for any taxable year.

Example: A, a calendar year taxpayer, in 1988 has AMTI of $10 million and a minimum tax NOL of $11 million. A may not use the NOLs to wipe out the entire $10 million of AMTI. A may use the NOL to offset only $9 million (90% of $10 million) of AMTI. The balance of $2 million in minimum tax NOL may be carried forward to 1989.

The alternative tax net operating losses may be carried back or forward in accordance with §172(b)(2). Thus, such losses may be carried back three years and forward 15. As provided in §172(b)(2), therefore, a taxpayer, must carry its alternative tax NOL to the third preceding year unless an election to forego the carryback period is made under §172(b)(3)(C).[220] If the entire amount of the loss is not absorbed by AMTI for such year, the remaining loss must be carried to the second preceding taxable year. To the extent the loss is not absorbed by AMTI in such year, it must be carried to the first preceding taxable year. Any remaining loss may then be carried forward to the 15 succeeding taxable years.

Comment: An alternative tax NOL is offset to the extent of available AMTI in the carryback or carryover year even though the taxpayer owed no AMT in that year.

Example: Corporation X incurs an alternative tax net operating loss of $25,000 in 1990. It does not elect to forego the carryback period. In 1987 it had an AMTI of $26,000 but it did not owe any AMT. The $25,000 NOL will be carried back and absorbed fully by the $26,000 of AMTI in 1987. A thus derives no minimum tax benefit from the alternative tax NOL.

Comment: A taxpayer with an alternative tax NOL should consider making an election under §172(b)(3)(C) to forego the entire carryback period if no minimum tax benefit would be derived from the carryback (*i.e.*, the taxpayer had no AMT liability in prior years). This will preserve the loss for use in future years.

The Conference Report clarifies that, in view of the parallel nature of the regular tax and AMT, any limits applying for regular tax purposes to the use by a consolidated group of NOLs or current year losses will apply for minimum tax purposes as well.[221]

(c) Effective Date

The rules discussed above apply for purposes of computing alternative tax net operating loss for taxable years beginning after December 31, 1986.[222] For purposes of computing net operating loss for taxable years beginning before January 1, 1987, that may be carried over to post-1986 years, however, the rules in effect at the time of enactment of the TRA 1986 apply.[223] Under a special rule, however, a corporation that has a pre-1987 deferred add-on minimum tax liability is required to adjust its NOL that may be carried forward to post-1986 years. Under this rule, the NOL that may be carried to a corporation's first taxable year beginning after December 31, 1986, must be reduced by any preferences that gave rise to the deferred add-on minimum tax.[224]

b. Items of Tax Preference

After taxable income has been adjusted as mandated by §§56 and 58, the next and final step in the computation of AMTI is to add back the sum of items of tax preference described in §57.[225] Items of tax preference are essentially items of exclusion or deduction from gross income which receive preferential treatment for regular tax purposes. To neutralize this preferential treatment, these exclusions and deductions are added back to taxable income to arrive at AMTI.

The items of tax preference are summarized below.

(1) Depletion Deduction

(a) General

Section 611 permits a taxpayer a reasonable allowance for depletion in the case of mines, oil and gas wells, other natural deposits, and timber. A depletion deduction, however, is allowed to a taxpayer only if: (i) the taxpayer has an economic interest [226] in the mineral property or standing timber; (ii) the property with respect to which depletion is claimed is exhaustible; and (iii) the costs with respect to which depletion is claimed are not represented by physical property. If such costs are represented by physical property a depreciation, rather than depletion, deduction may be claimed.

The Code provides two methods for computing a depletion deduction: (i) cost depletion (§§611 and 612), and (ii) percentage depletion (§§611, 613, and 613A). A taxpayer must compute its depletion under both methods and is allowed to use the method that produces the larger deduction. Note, however, that percentage depletion is not allowed with respect to timber as well as oil and gas (with certain exceptions) property. Section 613A specifies that, for taxable years beginning after 1974, percentage depletion is not available (with certain exceptions) for domestic and foreign oil and gas production. The exceptions include: (i) regulated natural gas, natural gas sold on a fixed contract, and certain geothermal deposits, and (ii) independent producers and royalty owners of domestic oil and gas.

Conceptually, cost depletion allows the taxpayer a deduction for that part of its cost (*i.e.*, the investment in the mineral property or timber) which is allocable to the mineral property (or timber) sold or otherwise used in

[220] Conference Report at II-262.
[221] Conference Report at II-283.
[222] §56(d)(2)(A).
[223] Act §701(f)(2)(A).
[224] Act §701(f)(2)(B).
[225] §55(b)(2).
[226] For a definition of "economic interest" *see* Regs. §1.611-1(b)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

producing the income for the taxable year in question. Regs. §1.611-2(a) provides that the cost depletion deduction may be computed by dividing the taxpayer's basis (as computed under §612) by the number of mineral units remaining as of the taxable year and by multiplying the result by the number of mineral units sold within the taxable year. The basis of mineral property, for cost depletion purposes, is usually the adjusted basis for determining gain or loss, and includes any oil and gas drilling and development costs which have been capitalized (Regs. §1.612-1(b)(1)). Since depletion deductions reduce the taxpayer's basis in the mineral property, cost depletion is no longer available once the taxpayer's basis has been reduced to zero.

As indicated above, the purpose behind cost depletion is to allow the taxpayer to recoup its investment in the mineral property on a tax-free basis. Percentage depletion, on the other hand, is an arbitrary allowance totally unrelated to the taxpayer's investment in the mineral property. It is computed as a specified percentage of gross income from the mineral property subject to a ceiling of 50% of the taxable income from the property (computed without regard to the depletion deduction). The applicable percentages for various mineral properties are specified in §613(b). Since percentage depletion is based on gross income from the mineral property, it may be claimed as long as the property produces gross income. Thus, it offers the possibility of recovering, as a depletion allowance, an amount far in excess of the taxpayer's investment in the property. For this reason, investment in hard minerals and, to a certain extent, in oil and gas, has been a popular way for taxpayers to produce a flow of tax-free cash. By the same token, percentage depletion has long been a favorite target of those seeking to close tax loopholes. Over the years, Congress has attacked this perceived tax-shelter in a number of ways:

(i) by reducing the allowable depletion percentages;

(ii) by enacting this item of tax preference; and

(iii) by reducing the amount of percentage depletion deduction for corporate taxpayers under §291.

Section 291(a)(2), as amended by the TRA 1986, provides that, in the case of iron ore and coal, the amount of percentage depletion deduction otherwise allowable under §613 to a corporate taxpayer will be reduced by 20% of the excess of the deduction over the property's adjusted basis at the close of the taxable year.

(b) Definition

The excess of the depletion deduction allowable [227] over the property's adjusted basis [228] at the end of the year, disregarding the current year's depletion deduction, is an item of tax preference.[229] In the case of a corporate taxpayer, the amount of tax preference for AMT purposes is computed after reduction of the preference amount under §291(a)(2).[230] The excess is computed on each separate "property" as defined for depletion purposes.[231] Accordingly, basis in one property will not reduce excess depletion in connection with another property.

The property's adjusted basis at the end of the taxable year is determined under §1016 and the regulations thereunder. No adjustment is made to the basis of property subject to depletion as a result of the minimum tax.[232]

The preference is measured on a cumulative basis. Depletion will not be considered an item of tax preference until the total depletion deductions have exceeded the adjusted basis of the property. Then, the entire amount of the percentage depletion in excess of that basis (but reduced by 20% under §291) will be considered an item of tax preference.

Example: Corporation A has a percentage depletion deduction of $50,000 in 1987 with respect to an iron ore property. At the end of the taxable year 1987, A's adjusted basis in the property is $30,000. A's preference amount before reduction under §291(a)(2) is ($50,000 - $30,000) = $20,000. The preference amount that will be added back to A's AMT for 1987 is ($20,000 - 20% of $20,000) = $16,000. A's depletion deduction for regular tax purposes is also $16,000.

(2) The Intangible Drilling and Development Costs (IDCs)

(a) General

With respect to intangible drilling and development costs incurred in the development of oil and gas properties, the taxpayer has an option to either capitalize or currently expense such costs.[233] The statutory authority for currently expensing the IDCs is provided in §263(c). The IDCs are those costs which, in and of themselves, have no salvage value. These costs include amounts paid for labor, fuel, repairs, hauling and supplies, or any of them, which are used: (i) in the drilling, shooting, and cleaning of wells; (ii) in such cleaning of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and (iii) in construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.[234] IDCs also include the cost of installing tangible equipment necessary for the drilling of wells and for the preparation of wells for production (although the equipment itself must be capitalized and depreciated). A well is considered complete when casing and a "Christmas Tree" have been installed. IDCs, however, do not include labor, supplies etc. used to install production facilities. For example, a taxpayer may not elect, under §263(c), to expense: (i) oil well pumps (on the initial completion of the well, and after the well has flowed for a time) including the necessary housing structures; (ii) oil well separators including the housing structures; (iii) pipelines from the wellhead to oil storage tanks as well as the oil storage tanks on the producing lease; (iv) salt water

[227] Regs. §1.57-1(h)(2); *See also* §611 and Regs. §1.611-1(a).
[228] §§1011, 1012, 1016(a)(2) and Regs. §1.57-1(h)(3).
[229] §57(a)(1).
[230] §59(f).
[231] §§57(a)(1) and 614. Under §614, however, mining interests may be aggregated. Aggregated properties constitute a single property.
[232] Regs. §1.57-1(h)(4).
[233] Regs. §1.612-4(a).
[234] *Id.*

disposal equipment and recycling equipment; and (v) pipelines from the oil storage tanks on the producing leasehold to a common carrier pipeline.[235] In addition, the option to capitalize or currently expense IDCs is not available with respect to capital items. For example, the costs of materials used in structures constructed in the wells, drilling tools, pipe, casing, tubing, tanks, engines, boilers, etc. must be capitalized and depreciated.[236] By the same token, expenditures which must be charged off as expense may not be capitalized. Examples of such expenditures are costs of labor, fuel, repairs, hauling, supplies, etc. incurred in connection with the operation of the wells and of other facilities on the property for the production of oil and gas.[237]

IDCs that are capitalized, but which relate to a nonproductive well may, at the taxpayer's election, be deducted as an ordinary loss in the taxable year in which the nonproductive well is completed.[238] The capitalized IDCs relating to a productive well, on the other hand, may be recovered through depletion, provided such costs are not represented by physical property.[239] Examples of such costs include ground clearing, draining, road making, surveying, geological work, excavation, grading, drilling, shooting, and cleaning of wells. If the capitalized IDCs are represented by physical property, such costs must be recovered through depreciation.[240] Examples of such costs include amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the premises of derricks and other physical structures.

The rules described above relating to IDCs incurred in developing oil and gas properties also generally apply to IDCs incurred in developing geothermal deposits. Section 613(e)(3) defines a geothermal deposit as a "geothermal reservoir consisting of natural heat which is stored in rocks or in an acqueous liquid or vapor (whether or not under pressure)." Percentage depletion is allowed with respect to a geothermal deposit and such a deposit is not treated as a gas well for purposes of the limits on percentage depletion provided in §163A.

As stated above, under §263(c) costs that normally would be required to be capitalized are allowed as a current deduction, provided the taxpayer so elects. This election provides the taxpayer with a timing benefit, allowing it to deduct immediately the costs incurred rather than deducting them over the life of the well, or the equipment.

In the case of an "integrated oil company," however, the amount that is otherwise allowable as a deduction under §263(c) is reduced by 30%.[241] "Integrated oil company" means any producer (within the meaning of §4998(a)(1)) of crude oil other than an independent producer within the meaning of §4992(b).[242] The 30% of the deduction that is disallowed in the current year may be capitalized and amortized ratably over a 60-month period beginning with the month in which such costs are paid or incurred.[243] Like IDCs deducted under §263(c), the costs that are capitalized and amortized under §291(b)(2) are subject to recapture as ordinary income under §1254 upon the disposition of the property.[244] Finally, the 30% portion of IDCs disallowed will not increase the property's depletable basis for cost depletion purposes.[245]

(b) Definition

The IDCs tax preference is the excess of the excess intangible drilling and development costs for the taxable year over 65% of the taxpayer's net income from oil, gas, and geothermal properties for that taxable year.[246] The IDCs tax preference amount, however, is computed separately for oil and gas and geothermal properties.[247]

For purposes of computing the IDC tax preference, excess IDCs are defined as the excess of the amount of intangible drilling and development costs paid or incurred with respect to oil, gas, (or geothermal) properties that the taxpayer elects to expense under §263(c) (but as reduced under §291(b)(1) for integrated oil companies) over the amount that would be allowed for the taxable year if the costs had been capitalized and amortized under one of the methods provided in §57(b).[248] Section 57(b), in turn, provides for: (i) a ratable amortization over a 120-month period beginning with the first month in which the production begins, or (ii) at the election of the taxpayer, any method permitted for determining cost depletion with respect to a well.

The net income from oil and gas (or geothermal) properties is defined as the gross income from all the taxpayer's oil, gas (or geothermal) properties less any deductions allocable to these properties reduced by the excess intangible drilling and development costs.[249]

Comment: Since deductions specifically allocable to the properties producing gross income are allowed in computing the net income from oil, gas, (or geothermal) properties, deductions allocable to wells that turn out to be nonproductive will not offset gross income derived from productive wells.

The computation of the IDCs preference may be illustrated by means of an example.

Example: Corporation A, an independent producer owning an economic interest in certain oil and gas properties, incurs $50,000 in IDCs during 1984 and elects to take a current deduction for these costs under §263(c). During 1984, the taxpayer derives $40,000 of gross income from the property and incurs $15,000 in operating expenses. The taxpayer's IDC tax preference is computed as follows:

[235] Rev. Rul. 70-414, 1970-2 C.B. 132.
[236] Regs. §1.612-4(c)(1).
[237] Regs. §1.612-4(c)(2).
[238] Regs. §1.612-4(b)(4).
[239] Regs. §1.612-4(b)(1).
[240] Regs. §1.612-4(b)(2).
[241] §291(b)(1).
[242] §291(b)(4).
[243] §291(b)(2).
[244] §291(b)(3).
[245] §291(b)(5).
[246] §57(a)(2)(A).
[247] §57(a)(2)(D).
[248] §57(a)(2)(B).
[249] §57(a)(2)(C).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

1. Calculation of Excess IDCs:	
IDCs currently deducted	$50,000
Less	
Allowed amortization deduction under §57(b)(1) (assuming the production begins in the 7th month of the year).	2,500
Excess IDCs	$47,500
2. Calculation of Net Income:	
Gross Income	$40,000
Less	
Allocable deductions	
IDCs	$50,000
Depletion	$ 6,000
Operating expenses	$15,000
Total Allocable Expenses	$71,000
Less	
Excess IDCs	$47,500
	$23,500
Net Income [GI − EIDCs]	$16,500
3. Calculation of IDC Tax Preference:	
Excess IDCs	$47,500
Less	
65% of Net Income	$10,725
Preference Amount	$36,775

Assuming the same facts as in the example above, but assuming that A is an integrated oil company, its preference amount will be computed as follows:

1. Calculation of Excess IDCs:	
IDCs currently deducted	$50,000
Less reduction under §291	$16,667
Less allowable amortization deduction under §57(b)(1) (assuming production begins in the 7th month)	$ 2,500
Excess IDCs	$30,833
2. Calculation of Net Income:	
Gross Income	$40,000
Less	
Allocable Deductions	
IDCs	$33,333
Amortization of §291 Amount	$ 1,667
Depletion	$ 6,000
Operating Expenses	$15,000
Total Allocable Deductions	$56,000
Less	
Excess IDCs	$30,833
	$25,167
Net Income [GI − EIDCs]	$14,833
3. Calculation of IDC Preference:	
Excess IDCs	$30,833
Less	
65% of Net Income	$ 9,641
Preference Amount	$21,192

Note, however, that IDCs incurred with respect to nonproductive wells do not give rise to a tax preference item. Under §57(a)(2)(B), such IDCs are disregarded in computing the excess IDCs. Nonproductive wells are those which are plugged and abandoned without having produced oil and gas in commercial quantities for any substantial period. Therefore, a plugged and abandoned well may have produced some oil and still be considered nonproductive, depending on the ratio of oil produced to costs of drilling.[250] The IDCs attributable to a nonproductive well may, at the taxpayer's election, be either capitalized or deducted currently as a loss, provided the taxpayer has not elected to deduct the IDCs currently under §263(c).

Consequently, a taxpayer will need to determine at the close of the taxable year, or at least by the time for filing its return, whether a well is productive. If the well is not determined to be nonproductive by the time its return is required to be filed, the IDCs with respect to such well will be subject to AMT.[251] The taxpayer, however, may later file an amended return and claim a refund for the amount of minimum tax paid with respect to such well if it subsequently proves to be nonproductive.[252]

(c) Election Under §57(b)(2)

For purposes of computing the excess IDCs, a taxpayer may use either the 120-month period prescribed in §57(b)(1) or elect, under §57(b)(2), to use the cost depletion method. If the taxpayer elects cost depletion, such election must be made within the time prescribed for filing the taxpayer's tax return (including extensions) for the taxable year in which the IDCs are paid or incurred.[253] The cost depletion election must be made for each well separately.[254] Thus, a taxpayer may make the cost depletion election for some of its wells. For purposes of computing the excess IDCs, the taxpayer may make the cost depletion election even if it uses some other method for computing its taxable income.[255] For partnerships, the §57(b)(2) election must be made at the partnership level.[256]

In computing cost depletion pursuant to a §57(b)(2) election, both depletable and depreciable IDCs are taken into account.[257] Depletable IDCs are those costs which are not represented by physical property (*e.g.*, costs incurred in ground clearing, draining, geological work, excavation, grading, etc.). Depreciable IDCs are those costs which are

[250] Conference Report. on H.R. 10612, 122 Cong. Rec. 9928 (Sept. 13, 1976), 94th Cong. 2d Sess. (1976).
[251] *Id.*
[252] *Id.*
[253] Temp. Regs. §7.57(d)-1(b)(1).
[254] Temp. Regs. §7.57(d)-1(b)(2).
[255] Temp. Regs. §7.57(d)-1(b)(4).
[256] Temp. Regs. §7.57(d)-1(b)(5).
[257] Temp. Regs. §7.57(d)-1(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

represented by physical property (*e.g.* wages, fuels, supplies, etc., used in the installation of casing, equipment, and physical structures). The depletable and depreciable IDCs are treated as if capitalized, added to basis, and recovered under Regs. §1.611-2(a) (dealing with the cost depletion method). Note, however, that in computing cost depletion pursuant to a §57(b)(2) election, only IDCs paid or incurred in the current year are taken into account.[258]

(d) Section 59(e) Election

Under §59(e), a taxpayer may elect to deduct IDCs ratably over a 10-year period beginning with the taxable year in which the IDCs are paid or incurred. If the taxpayer makes an election under §59(e), no preference amount will result from IDCs.[259]

(e) AMT Planning

Capitalization of IDCs under both Regs. §1.612-4 and Code §59(e) enables a taxpayer to eliminate the tax preference amount. The pros and cons of the two elections discussed below must be examined carefully.

(i) Under Regs. §1.612-4 election, the capitalized IDCs are recovered through depletion (if the expenditures do not result in physical property) or through depreciation (if the expenditures result in physical property) over the life of the well or equipment. Under the §59(e) election, on the other hand, IDCs are amortized ratably over a 10-year period beginning with the taxable year in which the IDCs are paid or incurred. Taxpayers may choose the option that provides the longer or the shorter recovery period depending upon their situation.

(ii) An election under Regs. §1.612-4 to capitalize IDCs is binding for all subsequent taxable years.[260] Consequently, a taxpayer may not shift between the current deduction method and the capitalization method from year-to-year. A §59(e) election, on the other hand, is not binding on subsequent taxable years. Thus, if the taxpayer made an election under §59(e) for the current year, IDCs paid or incurred in a subsequent taxable year may be deducted under §263(c), subject to §291(b)(1) restrictions.

Comment: There is a certain amount of tension between Regs. §1.612-4 election and §59(e) election. If the taxpayer makes a Regs. §1.612-4 election, it may not deduct IDCs paid or incurred in a subsequent taxable year under §263(c). If, however, the taxpayer is permitted to make an election under §59(e) with respect to IDCs paid or incurred in a subsequent taxable year, the taxpayer would be able to deduct a portion of such costs under §263(c). In view of §59(e)(3), however, it appears that §59(e) should prevail.

(iii) If the taxpayer claims percentage depletion, capitalization of IDCs under Regs. §1.612-4 will not yield any additional deduction. Capitalization of IDCs under §59(e), however, will yield an additional deduction for regular tax purposes.

(iv) An election under Regs. §1.612-4 applies to all IDCs paid or incurred with respect to all properties, not only in the current year but also in all subsequent years.[261] An election under §59(e), on the other hand, may be made with respect to any portion of IDCs paid or incurred during the taxable year.[262]

Comment: Since a taxpayer may elect to capitalize any portion of IDCs under §59(e) and deduct the rest under §263(c), subject to §291(b)(1) restrictions, §59(e) provides taxpayers with a planning tool to maximize the regular tax benefit of a current deduction under §263(c) while avoiding AMT liability at the same time.

(v) If the IDCs are capitalized and amortized pursuant to a §59(e) election, the deducted expenditures are upon a subsequent disposition of the property, recaptured as ordinary income under §1254. No such recapture, however, is required if the IDCs are capitalized in accordance with Regs. §1.612-4.

Comment: The significance of recapture under §1254 is considerably reduced after 1987 because of the elimination of the tax rate differential between ordinary income and capital gain.

(3) Bad Debt Reserves for Financial Institutions

(a) General

Under the amendments made by the Tax Reform Act of 1986, banks with gross assets of less than $500 million (§585) and thrift institutions (§593) are permitted to use a statutory formula to compute allowable bad debt deductions. In certain instances, the formula allows these taxpayers to claim larger deductions than they would be entitled to if they used the actual experience method.

To reduce the benefit of this preferential treatment somewhat, §291(a)(3) requires that the excess of deductions permitted for a reasonable addition to reserve for bad debts over the amount that would be allowable under the actual experience method be reduced by 20%.

(b) Definition

In the case of a financial institution to which §585 or §593 applies, the amount by which the deduction allowable for the taxable year for a reasonable reserve to bad debts exceeds the amount that would have been allowable had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience is an item of tax preference.[263] Note, however, that the entire amount of preference does not enter into the financial institution's AMTI computations. Since, for regular tax purposes, the amount of preference is subject to reduction by 20%, the financial institution's AMTI is increased by the amount of preference net of the 20% reduction.[264]

Example: In 1987, a financial institution's allowable deduction for a reasonable addition to its bad debt reserves is $100,000. The deduction that would be allowable under the actual experience method is $60,000. The preference amount before reduction under §291(a)(3) is therefore $40,000. The reduction

[258] *Id.*
[259] §59(e)(6).
[260] Regs. §1.612-4(e).
[261] *Id.*
[262] §59(e)(4)(A).
[263] §57(a)(4).
[264] §59(f).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

under §291(a)(3) is $8,000 (20% of $8,000). Consequently, the deduction for regular tax purposes is ($100,000 - $8,000)=$92,000. The amount that is required to be added back to AMTI as a tax preference item is therefore ($40,000 - $8,000)=$32,000.

(4) Tax-Exempt Interest

(a) General

The Tax Reform Act of 1986 restructured the Code provisions dealing with tax-exempt bonds, imposed certain additional restrictions and extended many existing restrictions.[265] Sections 103 and 103A of the 1954 Code are reorganized into 11 new sections: §103 and §§141-150. The Act changed the exempt financing lexicon by substituting the term "private activity bonds" for industrial development bonds." Interest on a private activity bond is taxable unless the bond is a "qualified bond." [266] Qualified bonds, the interest on which is tax-exempt, include:

(i) Qualified Exempt Facility Bonds (§142),

(ii) Qualified Mortgage Revenue Bonds (§143),

(iii) Qualified Small Issue Bonds (§144(a)),

(iv) Qualified Student Loan Bonds (§144(b)),

(v) Qualified Redevelopment Bonds (§144(c)),

(vi) Qualified §501(c)(3) Bonds (§145(a)).

Section 147 contains several restrictions on private activity bonds that applied previously to industrial development bonds. The substantial user requirement, the 120% bond maturity limit, the 25% limit on land acquisition cost, the existing property acquisition rules, the prohibition against the use of bond proceeds for skyboxes, airplanes, gambling establishments, etc., and the public approval requirements carry over from pre-1986 TRA law. The 1986 Act extended the 120% bond maturity limit to §501(c)(3) bonds. The prohibition for skyboxes, airplanes, gambling establishments, etc., was extended to all private activity bonds except for health facilities owned by §501(c)(3) organizations. Section 147(g) introduces a 2% cap on the amount of proceeds which can be spent for cost of issuance of the bonds.

The registration requirement and federal guaranty prohibition were carried over into §149. The information reporting requirements were extended to all tax-exempt bonds. Section 149(d) extends the prohibition on advance refunds to all private activity bonds except §501(c)(3) bonds.

Also, under post-1986 TRA §265(b), banks and other financial institutions may not deduct interest expense allocable to tax-exempt interest on bonds acquired after August 7, 1986.

(b) Definition

Interest on "specified private activity bonds" issued after August 7, 1986, is an item of tax preference.[267] Specified private activity bonds include all "private activity bonds" as defined in §141 with the following exceptions:

(i) The term "private activity bond" does not include Qualified §501(c)(3) Bonds as defined in §145;[268] and

(ii) The term "private activity bond" does not include any refunding bond if the refunded bond (or, in the case of a series of refundings, the original bond) was issued before August 8, 1986.[269] For this purpose, bonds issued before September 1, 1986, which are covered under the Joint Statement on Effective Dates of March 14, 1986, are considered to have been issued before August 8, 1986.[270] The Joint Statement provided generally that interest on bonds satisfying the pre-TRA 1986 definition of governmental bonds (as modified by an expanded security interest test like that adopted under the Senate Amendment) is not a preference if the bonds are issued before September 1, 1986.

Thus, interest on Qualified Small Issue Bonds, Qualified Mortgage Revenue Bonds, Qualified Student Loan Bonds, and Qualified Redevelopment Bonds, which is exempt from tax for regular tax purposes, is includible in AMTI as an item of tax preference.

In the case of tax-exempt interest dividends paid by a regulated investment company, the shareholders are required to include a portion of such dividends, to be determined under regulations to be prescribed, in AMTI as an item of tax preference.[271]

Finally, note that tax-exempt interest which is required to be included in AMTI under §57(a)(5)(A) may be reduced by allocable interest deductions disallowed under §265(b) for regular tax purposes.

(5) Charitable Contributions of Appreciated Property

(a) General

For income tax purposes, a corporation (other than an S corporation), is allowed a charitable contribution deduction if it satisfies the §170 and other appropriate requirements. Generally, a contribution is deductible only if it is made to or for the use of a permissible donee as provided in §170(c). In addition, the amount that may be deducted in any taxable year is limited under §170(b). Section 170(b)(2) provides that a corporate taxpayer (other than an S Corporation) may not deduct charitable contributions made to permissible donees in any year that exceed 10% of its "contribution base." The "contribution base" of a corporate taxpayer consists of its taxable income for the relevant taxable year computed without regard to:

(i) charitable contributions deduction under §170,

(ii) net operating loss carrybacks under §172,

(iii) certain special corporate deductions provided in §§241-247 and §§249-250, and

(iv) any capital loss carrybacks permitted under §1212(a)(1).[272]

[265] For a discussion of the changes, *see* Chapter 30, *supra*.
[266] §103(b)(1).
[267] §57(a)(5)(a).
[268] §57(a)(5)(C)(ii).
[269] §57(a)(5)(C)(iii).
[270] §57(a)(5)(C)(iv).
[271] §57(a)(5)(B).
[272] §170(b)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Contributions in excess of the 10% limit may be carried forward and deducted in the five succeeding taxable years to the extent such carryovers, when added to the contributions made in each of those years, do not exceed 10% of the contribution base.[273] The excess contributions are first carried over to the first succeeding taxable year and are deducted in that year to the extent of the difference between the contributions made in that year and 10% of the corporation's contribution base. Any unused contributions are then carried over to the second succeeding taxable year and similarly deducted subject to the 10% limit. This process continues through the fifth year. Any contributions that are not utilized in the fifth succeeding taxable year are lost permanently.

The rules that apply in case of charitable contributions of appreciated property are summarized below:

(i) If the contributed property is ordinary income property (*i.e.*, property that would produce ordinary income or short-term capital gain if sold), the general rule is that the contribution is taken into account at its adjusted basis.[274] For example, if a taxpayer contributes inventory with a fair market value of $100 and adjusted basis of $60, the amount of contribution is $60 and not $100. If, however, a corporation (other than an S corporation) makes a contribution of property described in §1221(1) or §1221(2) to a public charity or a private operating foundation, the allowable deduction is the sum of the taxpayer's adjusted basis in the property plus one-half of the unrealized appreciation.[275] In no event, however, is a deduction allowable for more than twice the taxpayer's adjusted basis in the property. Thus, if one-half of the unrealized appreciation exceeds the taxpayer's adjusted basis, the allowable deduction will be limited to twice the taxpayer's adjusted basis.[276] Also, for this exception to the general rule to apply, the donee's use of the property must be related to its exempt function and the property must not be transferred by the donee in exchange for money, other property or services.[277] This exception also applies to contributions of §1221(1) property made by a corporation (other than an S corporation, a personal holding company, or a service organization) to an educational organization described in §170(b)(1)(A)(ii) or a scientific research organization described in §41(e)(6)(B) provided, the contributed property is scientific equipment constructed by the donee and certain other requirements are met.[278]

(ii) If the contributed property is long-term capital gain property (*i.e.*, property that will produce long-term capital gain if sold), the general rule is that the amount of allowable contribution is the property's fair market value. If, however, the donated property is tangible personal property and the public charity to which it is donated puts it to an unrelated use, or if the property is donated to a private foundation not described in §170(b)(1)(D) the amount of allowable deduction is reduced by 28/46.[279] This 28/46 reduction does not apply if the contributed property is stock for which quotations are readily available as of the date of contribution on an established securities market.[280]

(b) Definition

For charitable contributions of "capital gain property," the amount by which the deduction allowable under §170 would be reduced if all "capital gain property" were taken into account at its adjusted basis, is an item of tax preference.[281] As previously stated, "capital gain property" means any capital asset (including §1231 assets) the sale of which will result in a long-term capital gain.[282]

In determining the amount of preference for charitable contributions of capital gain property the following rules apply:

(i) The taxpayer computes the amount by which the charitable deduction would have been reduced by taking into account all capital gain property (including loss property) at its adjusted basis. Thus, unrealized gain on appreciated property is offset by unrealized loss on the loss property.

(ii) The amount of preference is determined by disregarding any amount that is carried forward to another year for purposes of regular tax.[283] Consequently, if a portion of a charitable contribution deduction is carried forward because it exceeds the 10% limit, the portion so carried forward will not increase the amount of preference until it is allowed as a deduction for regular tax purposes.

(iii) The preference does not apply to carryovers of the deduction with respect to charitable contributions made before August 16, 1986.[284]

Example: A, a calendar year taxpayer, makes a contribution of capital gain property to a Church in 1987 which is subject to the 10% limit. At the time of the contribution, the property's fair market value is $50,000 and its adjusted basis is $40,000. For 1987, A's contribution base is $300,000. The amount of allowable deduction for 1987 is, therefore, 10% of $300,000, or $30,000. Consequently, for regular tax purposes, A may deduct $30,000 in 1987 and carryover the balance of $20,000 to 1988. To compute the preference amount for 1987, however, the amount of deduction is limited to its adjusted basis. Using a pro rata allocation of adjusted basis rule, the $30,000 charitable contribution deductible in 1987 has an adjusted basis of 30,000/50,000 x $40,000 = $24,000. Consequently, the amount of preference for 1987 is $30,000 - $24,000 = $6,000.

Comment: A corporate taxpayer owning loss "capital gain property" should consider combining it with appreciated "capital gain property" in his gift to charity to eliminate or reduce the amount of preference.

[273] §170(d)(2).
[274] §170(e)(1)(A).
[275] §170(e)(3).
[276] §170(e)(3)(B).
[277] §170(e)(3)(A).
[278] §170(e)(4).
[279] §170(e)(1)(B).
[280] §170(e)(5).
[281] §57(a)(6)(A).
[282] §170(b)(1)(C)(iv).
[283] H.R. Rep. No. 426, 99th Cong., 1st Sess., p. 313 (1985) ("House Report").
[284] Act §701(f)(4).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(6) ACRS and Amortization on Property Placed in Service Before 1987

For property placed in service before January 1, 1987 (to which §§56(a)(1) and 56(a)(5) do not apply), the amount computed under §§57(a)(2), 57(a)(3), 57(a)(4) and 57(a)(12), as in effect prior to the enactment of TRA 1986, remains an item of tax preference.[285]

Note: The preference amounts computed under §§57(a)(3) and 57(a)(12)(A) apply to personal holding companies only.

Section 57(a)(2) dealt with the preference amounts with respect to non-ACRS deductions taken on real property.

Under that provision, the excess of accelerated depreciation deduction allowable with respect to each §1250 property for the taxable year over the amount that would have been allowable as a deduction for that taxable year if the taxpayer had depreciated the property using a straight-line method for each taxable year of the property's useful life, was an amount of tax preference.

Section 57(a)(3) dealt with the preference amounts with respect to non-ACRS accelerated depreciations deductions taken on leased personal property. Under that paragraph, the excess of the accelerated depreciation deduction allowable with respect to each §1245 leased property for the taxable year over the amount that would have been allowable as a deduction for the taxable year if the taxpayer depreciated the property using a straight-line method for each taxable year of the property's useful life, was an amount of tax preference.

Section 57(a)(4) dealt with the preference amounts with respect to amortization of pollution control facilities. Under that paragraph, the excess of amortization deduction allowable for the taxable year under the 60-month write-off election provided by §169 over the amount that would otherwise have been allowable as a deduction under §167 or §168 was an amount of tax preference.

Section 57(a)(12)(A) dealt with preference amounts relating to ACRS depreciation deductions taken on leased recovery property (other than 19-year real property and low income housing). Under that paragraph, the excess of the deduction allowed under §168(a) for the taxable year over the deduction that would have been allowed if the taxpayer used the straight-line method over a recovery period specified in the following table, was an item of tax preference.

Type of Property	*AMT Recovery Period*
3-year Property	5 years
5-year Property	8 years
10-year Property	15 years
15-year Public Utility Property	22 years

Section 57(a)(12)(B) dealt with preference amounts relating to ACRS deductions taken on 19-year real property or low income housing. Under that provision, the excess of ACRS deduction for each 19-year real property on low income housing property allowed under §168(a) for the taxable year over the amount that would have been allowed if the taxpayer had depreciated the property using the straight-line method over 19 years for real property and 15 years for low income housing was an item of tax preference.

[285] §57(a)(7).

c. Coordination With Certain Limitations

Section 59(h) provides that, in computing AMTI of a taxpayer for a taxable year, certain limitations of the Code on deductibility of losses will be applied by taking §56 adjustments into account and by disregarding any deductions which are items of tax preference under §57.

The limitations specified in §59(h) include §465, §704(d) and §1366(d). Section 465 provides that an individual or a C corporation engaged in an activity covered by that section may deduct a loss only to the extent of the aggregate amount with respect to which the taxpayer is at risk. Section 704(d) provides that a partner's distributive share of partnership loss shall be limited only to the extent of the adjusted basis of such partner's interest in the partnership at the end of partnership's taxable year in which the loss occurred. Section 59(h) authorizes the Treasury to specify by regulations other provisions of the Code which are subject to this coordinating rule.

d. Optional 10-Year Write-Off of Certain Adjustments and Preferences

(1) General

With respect to certain capital expenditures for which the Code provides a preferential treatment (*i.e.*, a current deduction) and which are designated as items of adjustment or preference under §§56 and 57 respectively, §59(e) provides the taxpayer, if it chooses, with an option to elect a capital treatment and eliminate the adjustment or preference amount. Note that the §59(e) election is an added luxury in the sense that all expenditures subject to this election may be deferred or capitalized under other Code provisions. Thus, a taxpayer desiring to eliminate the preference amount may choose between capital treatment under §59(e) and capital treatment under other Code provisions.

If an election is made under §59(e) with respect to an expenditure, such expenditure is capitalized and amortized in accordance with §59(e) for all purposes of the Code and not just §55 purposes. Accordingly, once an election under §59(e) is made with respect to an expenditure, such expenditure is amortized under §59(e) for both regular tax and AMT purposes and no deduction is allowed under any other section of the Code.[286] Any amount to which an election under §59(e) applies is not treated as an item of adjustment under §56 or an item of tax preference under §57.[287]

(2) The Election

An election under §59(e) is permissible only with respect to "qualified expenditures." "Qualified expenditures" means any amount that would, absent a §59(e) election, be allowable as a deduction in the year paid or incurred under:

[286] §59(e)(3).
[287] §59(e)(6).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(i) §173 (relating to circulation expenditures)

(ii) §263(c) (relating to IDCs)

(iii) §616(a) (relating to mining development expenditures), or

(iv) §617(a) (relating to mining exploration expenditures).[288]

If an election under §59(e) is made with respect to circulation expenditures deductible currently under §173, such expenditures are capitalized and amortized ratably over a 3-year period beginning with the taxable year in which they are paid or incurred.[289] On the other hand, if a §59(e) election is made with respect to any other qualified expenditure, such expenditure must be capitalized and amortized ratably over a 10-year period beginning with the taxable year in which the expenditures were paid or incurred.[290]

Section 59(e)(4)(A) provides that an election under §59(e) may be made with respect to any portion of a qualified expenditure. This implies that, if a taxpayer chooses to capitalize only a portion of a qualified expenditure (*e.g.*, circulation expenditures), paid or incurred during a taxable year, the balance may be deducted currently under the applicable Code provision, (§173 in the case of circulation expenditures). This creates a tension between §59 and other Code or regulatory provisions which govern the capitalization of qualified expenditures. For example, an election to capitalize circulation expenditures under §173 applies to all such expenditures chargeable to capital account. The exercise of an option to defer and capitalize the mining exploration costs applies to all such costs paid or incurred during the taxable year; an election under §616(b) to capitalize the mining development costs applies to all such costs paid or incurred during the taxable year on a mine-by-mine basis; an election to capitalize IDCs under Regs. §1.612-4 applies to all such costs paid or incurred during the taxable year with respect to all properties. Since §59(e)(3) expressly precludes the application of any other Code section to the amount with respect to which a §59(e) election is made, however, it appears that §59 should override other Code or regulatory provisions which would preclude a current deduction of only a portion of qualified expenditure.

Comment: The fact that a §59(e) election may be made for a portion of a qualified expenditure confers important advantages on the taxpayer. For example, where the taxpayer cannot absorb the full amount of a current deduction, either due to a potential minimum tax liability or some other reason (*e.g.*, expiring net operating loss carryovers), capitalization under the normal Code provisions exacts a penalty: the taxpayer must forego the current deduction and capitalize the entire amount of the expenditure. Section 59(e) offers a superior choice in such a case by permitting the taxpayer to capitalize just the right amount and claim a current deduction for the balance. Also, the §59(e) election may be utilized to defer the right amount of mining exploration and development expenditures and IDCs to maximize the percentage depletion deduction by avoiding the impact of the 50% and 65% taxable income limits found in §613(a) and §613A(d)(1), respectively.

(3) Basis Adjustment and Dispositions of Underlying Property

The statute is silent as to the basis adjustments required upon the capitalization of qualified expenditures under §59(e). Specifically, when a qualified expenditure is capitalized under §59(e), the question arises: should the basis of the underlying property be increased by the amount of the capitalized expenditure; or does an election under §59(e) create a separate asset with a basis equal to the amount of the capitalized expenditure? A related question involves the tax treatment to be accorded to the unamortized portion of the expenditures capitalized under §59(e) upon a sale, exchange, or other disposition of the underlying property. The answer to this, as well as other related questions (*e.g.*, recapture) will, of necessity, depend upon how the basis adjustment question is answered.

Section 1016(a)(23), added by TRA 1986, provides that a proper adjustment shall be made to the basis of the property for amounts allowed as a deduction under §59(e).[291] It might be inferred from this that, upon making the §59(e) election, the taxpayer must add the amount of the capitalized expenditures to the property's basis. After all, if the property's basis must be reduced for deductions taken under §59(e), it is logical to assume that the property's basis should initially be increased by the amount of the expenditures capitalized under §59(e). Such an inference could be accepted as accurate were it not for the problems caused by §59(e)(3).[292] For example, if the mining development expenditures capitalized under §59(e) are added to the depletable basis of the mining property, the taxpayer would be entitled to recover such expenditures through depletion deductions. Depletion deductions are, however, expressly barred by §59(e)(3) with respect to expenditures capitalized under §59(e). Again, if the mining property in the above example is abandoned as worthless before the capitalized development expenditures have been fully recovered, the taxpayer would be entitled to a loss deduction under §165 with respect to the unamortized portion of the mining development expenditures capitalized under §59(e). A loss deduction under §165 for amounts capitalized under §59(e), however, is similarly barred by §59(e)(3). Finally, §59(e)(3) can also be read to deny a basis adjustment attributable to the unamortized portion of the amounts capitalized under §59(e) for purposes of computing gain (or loss) upon the sale or exchange of the underlying property.[293]

An alternative approach would be to regard a §59(e) election as creating an intangible nontransferable asset, separate and apart from the underlying property with a

[288] §59(e)(2).
[289] §59(e)(1).
[290] *Id.*

[291] The statute mistakenly refers to §59(d). It is expected that this error will be corrected in a forthcoming technical corrections bill.

[292] Section 59(e)(3) provides that "Except as provided in this subsection, no deduction shall be allowed under any other section for any qualified expenditure to which an election under this subsection applies."

[293] *See* Linden & Meyer, "Changes by TEFRA in Treatment of Oil, Gas and Mining Will Significantly Affect Planning," 57 J. of Tax. 355 (1982), which pointed out similar problems created by the predecessor of §59(e), *i.e.*, §58(i).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

basis equal to the amount of expenditures capitalized under §59(e). This approach would eliminate the double deduction problem and the problems encountered at the abandonment or sale of property under the first approach. Where the taxpayer, for example, capitalizes $10,000 of mining exploration costs such capitalization would create an asset separate and apart from the underlying mining property with a basis of $10,000. This asset would be amortized ratably over a 10-year period with the taxpayer getting a $1,000 deduction in each of the 10 years. If the mining property was abandoned before the $10,000 mining exploration costs had been fully amortized, the taxpayer would not face the problem of denial by §59(e)(3) of a loss deduction (under §165) attributable to the unamortized portion because it would simply continue to amortize the unamortized portion until exhausted. Again, if the mining property were sold, the capitalized mining exploration costs would not figure in the computation of gain (or loss) from the property, and any unamortized portion of the costs would be continued to be amortized by the taxpayer, thus avoiding the problems posed by §59(e)(3). This separate asset approach, however, is not without its problems. For example, §59(e)(5) requires a recapture of the IDCs, the mining exploration, and the mining development costs when the underlying property is disposed of. In the example above, if the taxpayer disposed of the mining property after three years the question arises: is the taxpayer required to recapture only $3,000 of the mining exploration costs or must the taxpayer recapture the entire $10,000? If the taxpayer is required to recapture only $3,000, the balance of $7,000 (for which the taxpayer will be taking deductions in future years) will go unrecaptured, a situation which is contrary to the mandate of §59(e)(5). On the other hand, if the entire $10,000 must be recaptured, the taxpayer would be required to recapture deductions which it has not taken, a situation which would require a statutory amendment to be effective. Also, if the corporation dissolves before the $10,000 mining exploration costs have been fully amortized, the deductions for the unamortized portion would be lost forever.

A third, and perhaps the most practical, approach would be to clearly and carefully circumscribe, by regulations, the scope of the application of §59(e)(3). As drafted, the sweeping language of that paragraph would seem to deny any deduction for the amounts capitalized under §59(e) under any other Code section including a deduction at the time of abandonment or sale of the underlying property. This perhaps, was not the legislative intent. The concern behind the enactment of §59(e)(3), perhaps, was to prevent a double deduction for the amounts capitalized under §59(e), *i.e.*, once under §59(e) and again as a depletion, or amortization deduction under other Code provisions (*e.g.*, §§611, 613, etc.) when the capitalized amounts are added to the basis of the underlying property. If this reading of the legislative intent is accurate, the inference can be drawn that Congress expected the amounts capitalized under §59(e) to be added to the basis of the underlying property. As a matter of fact, if the scope of §59(e)(3) is limited so that it does not apply to amounts capitalized under §59(e) upon the sale, exchange, or other disposition of the underlying property, all other pieces of the puzzle (*i.e.*, the initial basis adjustment upon capitalization of qualified expenditures under the §59(e), the §1016(a)(23) basis adjustment, the §59(e)(5) recapture provision, the problem of the unamortized amounts, etc.) fall into place. Under this approach, the amounts capitalized under §59(e) would be added to the basis of the underlying property, but only for purposes of computing gain or loss from a sale, exchange or other disposition of the property. This basis would be adjusted under §1016(a)(23) for all deductions taken under §59(e). If the underlying property were abandoned at a time when the §59(e) amounts had not been fully amortized, the taxpayer would be entitled to a loss deduction under §165 for the unamortized amounts. Similarly, if the underlying property were sold or exchanged, the taxpayer's gain would be reduced by the unamortized portion, and the recapture provisions of §59(e)(5) would apply to the extent the §59(e) amounts had been amortized by the taxpayer. Finally, in the case of a nontaxable transfer of the underlying property (*e.g.*, a §351 exchange), the taxpayer's basis in the property received in exchange (*i.e.*, stock in the transferee corporation in a §351 exchange) would reflect the unamortized portion of the §59(e) amounts, the §59(e) amortization schedule would be extinguished, and the transferee would amortize the inherited §59(e) amounts as part of the inherited basis in the underlying property. To the extent the taxpayer has amortized §59(e) amounts prior to the transfer, the §59(e)(5) recapture provisions should apply. To effectuate this approach, only two clarifications are needed: (i) that the amounts capitalized under §59(e) are to be added to the basis of the underlying property, but only for purposes of computing the gain or loss (or the basis of property received in a nontaxable exchange) upon the sale, exchange, or other disposition of the underlying property; and (ii) that §59(e)(3) does not apply when the underlying property is sold, exchanged, or otherwise disposed of.

(4) Time and Manner of Making Election

The statute is silent as to the time and manner of making an election under §59(e). It only states that "an election under this subsection may be revoked only with the consent of the Secretary." [294] In view of this silence, guidance provided by the Service under the predecessor of §59(e), *i.e.*, §58(i), may be relied upon at least until the Service issues revised rules.

Temp. Regs. §5f.O(a)(2)(i) [295] provides that an election under §58(i) may be made no later than the due date of the return for the taxable year (including extensions) for which the election is effective.

Comment: The timing of the election provides a taxpayer with an opportunity to plan for avoiding AMT by capitalizing under §59(e) the right amount of expenditures subject to that subsection and deducting the balance currently.

Temp. Regs. §5f.O(a)(3) provides that an election under §58(i) may be made by attaching a statement to the income tax return for the taxable year for which the election is made. The statement is required to contain the following information:

[294] §59(e)(4)(B).
[295] *See* T.D. 7870, dated January 2, 1983.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(i) The name, address, and taxpayer identification number of the electing taxpayer;

(ii) The fact that an election is being made;

(iii) The Code section under which the election is being made;

(iv) The taxable year and the property to which the election applies; and

(v) The information necessary to show that the taxpayer is entitled to make the election.

(5) The Recapture of Amounts Subject to the Section 59(e) Election

Section 1254, as revised by the TRA 1986, provides that, upon the disposition of an interest in a mine, well, or other natural deposit, taxpayer must recapture as ordinary income the aggregate amount of "(i) expenditures deducted under §263, 616, or 617 with respect to such property which, but for such deduction, would have been included in the adjusted basis of such property; and (ii) the amounts deducted as depletion under §611 which reduced adjusted basis of such property." The amount of gain recaptured as ordinary income is limited to the amount of gain realized upon the disposition of the property.

Section 59(e)(5)(A) requires, that upon the disposition of any §1254 property, any expenditures allocable to such property which were deducted under §59(e) must be recaptured as ordinary income. Thus, IDCs and mining development and exploration costs which were capitalized and amortized pursuant to §59(e) election must be recaptured as ordinary income when the underlying property is disposed of.

With respect to mining exploration expenditures, §59(e)(5)(B) acts as a back-stop to §59(e)(5)(A). Thus, any mining exploration expenditures capitalized and amortized under §59(e) that are not recaptured as ordinary income under §1254 will be recaptured as ordinary income under §617(d).[296] Section 617(d) provides that, upon the disposition of a mining property, a portion of the mining exploration expenditures deducted currently under §617(a) must be recaptured as ordinary income. The portion required to be recaptured is the lesser of the adjusted mining exploration expenditures and the amount of the gain.

2. Tentative Minimum Tax

The tentative minimum tax for corporate taxpayer's is equal to 20% of the alternative minimum tax base, reduced by the alternative minimum tax foreign tax redit and, to a limited extent, by the pre-1986 TRA investment tax credit.[297] The foreign tax credit and the investment tax credit, in conjunction with the AMT net operating loss deduction, may not reduce tentative AMT below 10% of tentative AMT computed without regard to these credits and the net operating loss deduction. The AMT base is computed by subtracting the exemption amount from the AMTI.[298]

a. The Exemption Amount

The exemption amount for a corporate taxpayer is $40,000.[299] This exemption amount, however, is phased out by 25 cents for each dollar after AMTI reaches $150,000.[300] The entire exemption amount, therefore, is phased out when AMTI reaches $310,000. Thus, for a corporate taxpayer the AMT base is equal to AMTI when AMTI reaches $310,000 for a taxable year.

b. Alternative Minimum Tax Foreign Tax Credit

(1) General

The United States taxes domestic corporations and individual citizens and resident aliens on their worldwide income. This worldwide taxation may result in double taxation of the foreign income, *i.e.*, once in the country of source and again by the United States. With a view to avoid or at least mitigate this potential double taxation of U.S. persons, Congress enacted a dollar-for-dollar credit against U.S. tax for income taxes paid to foreign countries on foreign income. The foreign tax credit provisions are contained in §§901-908 and §960.

Since the basic function of the foreign tax credit is to prevent double taxation of the foreign source income and not to reduce U.S. tax on U.S. source income, §904 provides a limit on the foreign tax credit to ensure that the credit is not greater than the U.S. tax attributable to foreign income. The §904 limit is expressed as follows:

Tentative U.S. Tax
×
Foreign Source Taxable Income
÷
Worldwide Taxable Income

Any foreign taxes disallowed because of the foreign tax credit limit may be carried back two years and forward five under §904(c).

(2) Computation of AMT Foreign Tax Credit

AMT foreign tax credit is computed by utilizing the regular tax foreign tax credit rules, with the following modifications:

(i) In the formula for computing §904 limit, tentative AMT (before reduction by the foreign tax credit) is substituted for tentative U.S. tax[301] and foreign source taxable income and worldwide taxable income are computed by making the adjustments provided in §§56 and 58 as well as by adding back the items of tax preference provided in §57 to taxable income.[302]

Note that book income adjustment will not result in any change in the §904 AMT foreign tax credit limit. This is because, for purposes of the §904 fractions, the amount of book income adjustment is assigned the same proportionate source and character of income as AMTI before such adjustment.[303]

[296] *See* §§59(e)(5)(B) and 617(d)(5).
[297] §§655(b)(1) and 38(c)(3).
[298] §55(b)(1)(A).
[299] §55(d)(2).
[300] §55(d)(3)(A).
[301] §59(a)(1)(A).
[302] §59(a)(1)(B).
[303] §59(a)(1)(C).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Comment: The allocation of adjustments and preferences to U.S. or foreign source income may change the ratio of foreign source taxable income to worldwide income for AMT foreign tax credit purposes. The AMT foreign tax credit allowable under §904 may, therefore, be more or less than the foreign tax credit allowable under §904 for regular tax purposes. Taxpayers will, therefore, be required to keep track of credit carryovers separately for regular and AMT purposes.

(ii) The amount of AMT foreign tax credit allowable under §904 for the taxable year is subject to another limit: it may not offset more than 90% of tentative minimum tax computed without regard to the foreign tax credit and alternative minimum tax net operating loss deduction.[304]

Example: In 1987, a taxpayer has $10 million in AMTI (without regard to any AMT net operating loss deduction). The taxpayer's tentative minimum tax liability (computed without regard to the AMT foreign tax credit and NOL deduction) is, therefore, $2 million. Accordingly, the AMT foreign tax credit may not exceed 90% of $2 million, or $1,800,000.

Stated differently, the AMT foreign tax credit may not reduce taxpayer's tentative AMT liability (computed without regard to the foreign tax credit and NOL deduction) below 10% of such tax. Thus, in the example above, the AMT foreign tax credit may not reduce the taxpayer's tentative minimum tax below 10% of $2 million, or $200,000. The mechanics of the 90% limit computation are provided in §59(a)(2)(A). It provides that AMT foreign tax credit is limited to the extent the tentative minimum tax computed under §55(b)(1)(A) exceeds 10% of such amount determined without regard to the alternative minimum tax NOL deduction. The amount determined under §55(b)(1)(A) is 20% of the AMT base. The application of §59(a)(2)(A) is illustrated by the following example.

Example: Corporation A has $10 million AMTI in 1988 and has a $2 million NOL deduction. It computes the 90% limit under §59(a)(2)(A) as follows:

(i) Tentative AMT Determined Under §55(b)(1)(A):
AMTI = $10 million
NOL Deduction = $2 million
AMT Base = $10 million - $2 million = $8 million
Tentative AMT = 20% of $8 million = $1.6 million

(ii) Tentative AMT Under §55(b)(1)(A) Without Regard to NOL Deduction:
AMTI = $10 million
Tentative AMT = 20% of $10 million = $2 million
10% of Tentative AMT = $200,000

(iii) Excess of (i) over (ii):
Section 59(a)(2)(A) Limit = $1,600,000 - $200,000 = $1,400,000.

Thus, A's AMT foreign tax credits will be disallowed to the extent they exceed $1.4 million, even though its §904 limitation is greater than $1.4 million. Note also that A will have a tentative AMT of at least ($1.6 million - $1.4 million) = $200,000 which is 10% of $2 million tentative AMT liability computed under §55(b)(1)(A) without regard to the alternative minimum tax NOL deduction.

Comment: The reason for computing the 90% limit without regard to the AMT net operating loss deduction is to coordinate this limitation with the 90% limit on AMTI that may be offset by the AMT net operating loss deduction in any year. The 90% limit on NOL deductions is applied before the 90% limit on the AMT foreign tax credit.[305] Thus, if the alternative tax NOL deduction in any taxable year reduces the §55(b)(1)(A) tentative AMT below 10% of such tax (computed without regard to NOL deductions) no AMT foreign tax credit will be allowed that year against the minimum tax.

Example: A has an AMTI of $10 million and an NOL deduction of $11 million in 1987. Since the NOL deduction may offset AMTI only up to (90% of $10 million) = $9 million, A's tentative minimum tax computed under §55(b)(1)(A) is (20% of $ 1 million) $200,000. Since the 90% limitation on AMT foreign tax credits under §59(a)(2)(A) is also (10% of $2 million tentative AMT under §55(b)(1)(A) computed without regard to NOL deductions) no AMT foreign tax credit will be allowed A in 1987.

Any AMT foreign tax credit that is disallowed either due to the the §904 limit or the 90% limit discussed above is available as a carryover in accordance with §904(c).[306] The amount of AMT foreign tax credit allowable in the carryover years, however, will again be subject to the two limits.

c. Investment Tax Credit

The Tax Reform Act of 1986 generally repealed the investment tax credit for assets placed in service after December 31, 1985. Under a transition rule, however, a credit is permitted for assets for which a binding contract existed on December 31, 1985. To qualify for the credit under the transitional rule, the property had to be placed in service by a specified date based on the recovery class to which the property belonged. Also, the investment tax credit carryovers, however, that had not expired by December, 1985 are allowable in 1986 and subsequent years. However, the carryovers are subject to a reduction of 35%. The transition property investment tax credits are also subject to a reduction and a basis adjustment under §49.

Section 38(c)(3) permits C corporations to apply carryover and transition-rule property investment credits against AMT to a limited extent. Thus, in a year in which a C corporation is in an AMT position, the carryover of transition property investment credits will be allowed: (i) to the extent sufficient to reduce net regular tax liability (*i.e.*, regular tax, net of credits allowed under subparts A and B) to 75% of the tentative minimum tax for the taxable year, or (ii) in an amount equal to 25% of the tentative minimum tax for the taxable year; whichever is greater. The investment credits, however, will not be permitted to reduce the tax payable below 10% of the amount that could be determined under §55(b)(1), without regard to the alternative tax NOL deduction and the AMT foreign tax credit.

[304] §59(a)(2)(A).

[305] Conference Report at II-262.

[306] §59(a)(2)(b).

3. Net AMT Liability

After a taxpayer has computed its tentative minimum tax for the taxable year it is compared with taxpayer's "regular tax" for the taxable year. If the tentative minimum tax is greater than the regular tax, the taxpayer pays the tentative minimum tax as its final tax liability for the taxable year. Technically, the tentative minimum tax, if greater than the regular tax, has two components, the regular tax and the net alternative minimum tax, with the excess of the tentative minimum tax over the regular tax being referred to as taxpayer's "net alternative minimum tax liability."

As will be discussed, *infra*, regular tax is not reduced by any nonrefundable credits (other than the foreign tax credit and, to a limited extent, the investment tax credit) prior to comparing it with tentative AMT. If, however, the comparison reveals that the regular tax is greater than the tentative AMT, nonrefundable credits are applied to reduce regular tax, but not below tentative AMT.[307] Any nonrefundable credits that are not used against regular tax due to the tentative AMT limit, are available as carryovers under the normal Code provisions governing the carryovers of such credits.

a. Regular Tax

"Regular tax" as used in the AMT context is a term of art and is not synonymous with the amount of "regular tax" that a taxpayer may owe for a taxable year. For purposes of AMT, "regular tax" means the regular tax liability for the taxable year (as defined in §26(b)), computed without regard to any increase under §47, and reduced by the foreign tax credit and, to a limited extent, investment credit.[308] Thus, for purposes of comparison with tentative AMT, the regular tax undergoes two types of adjustments:

(i) as specified in §§26(b) and 55(c)(1), certain taxes are disregarded, and

(ii) the only nonrefundable credits allowed against regular tax are the foreign tax credit and the investment tax credit.

(1) Taxes Disregarded

In computing "regular tax" for AMT purposes, taxes imposed under the following Code sections are disregarded:[309]

(i) §47 (pertaining to increases in tax);

(ii) §55 (relating to the minimum tax);

(iii) §531 (relating to the accumulated earnings tax);

(iv) §541 (relating to the personal holding company tax);

(v) §1351(d)(1) (relating to recoveries of foreign expropriation losses);

(vi) §7518(g)(6)(A) (relating to nonqualified withdrawals from capital construction funds taxed at highest marginal rate); and

(vii) §881 (relating to certain income of foreign corporations.)

(viii) §402(e) (relating to the special income tax on certain lump-sum distributions from tax-qualified reitrement plans).

(2) Non-Refundable Credits

The regular tax computed without regard to the taxes described above is compared with the tentative AMT as computed under §55(b)(1)(A) (*i.e.*, before reduction by the AMT foreign tax credit). If the tentative AMT is greater than the regular tax then (except for the exceptional case where the AMT foreign tax credit is so much greater than the regular tax foreign tax credit that it reduces the tentative AMT below the regular tax), no nonrefundable credits (other than foreign tax credit, and to a limited extent, the investment tax credit) will offset regular tax and AMT. In such a case, the taxpayer will first reduce the regular tax by the regular tax foreign tax credit and the tentative AMT by the AMT foreign tax credit subject, to the 90% limit of §59(a)(2)(A). It will then use the investment credit against regular tax and tentative AMT to the extent permitted by §38(c)(3). Note, however, that, if the amount of tax payable has been reduced by the AMT foreign tax credit to 10% of tentative tax as computed under §55(b)(1)(A) (without regard to net operating loss deduction and AMT foreign tax credit), no investment tax credit will be allowed against tentative AMT.

If, however, the regular tax is greater than tentative AMT determined under §55(b)(1)(A), nonrefundable credits can be used to reduce the regular tax but not below tentative AMT, unless the regular tax foreign tax credit is so much greater than the AMT foreign tax credit that it reduces the regular tax to equal tentative AMT. In such a case, the nonrefundable credits are applied to reduce the regular tax in accordance with the rules set forth below.

(i) As a first step, the taxpayer reduces the regular tax by the regular tax foreign tax credit and the tentative AMT determined under §55(b)(1)(A) by the AMT foreign tax credit subject to the 90% limit provided in §59(a)(2)(A).

(ii) Assuming the regular tax as reduced by the foreign tax credit is greater than the tentative AMT (as reduced by the AMT foreign tax credit), the clinical testing credit (§28) is applied to reduce the regular tax, but not below tentative AMT.[310]

(iii) Next, the credit for producing fuel from a nonconventional source (§29) is applied to reduce the regular tax to the extent the regular tax (as reduced by the §§27 and 28 credits) exceeds the tentative AMT (as reduced by the AMT foreign tax credit).

(iv) Next, the general business credit (*i.e.*, the sum of the investment credit determined under §46(a), the targeted jobs credit determined under §51(a), the alcohol fuels credit determined under §40(a), the research credit determined under §41(a), and the low income housing credit determined under §42(a)) is applied against the regular tax. The amount of this credit allowable in any taxable year is limited to the lesser of:

[307] §55(c)(1) and (2).
[308] §§55(c) and 38(c)(3).
[309] §§26(b) and 55(c)(1).
[310] §28(d)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(i) the allowable portion of taxpayer's net regular tax liability, or

(ii) the excess of taxpayer's net regular tax liability over tentative AMT.[311]

Net regular tax liability means regular tax reduced by the §§27, 28 and 29 credits.[312] The allowable portion of net regular tax liability means $25,000 plus 75% of so much of net regular tax liability for the taxable year as exceeds $25,000.[313] Any general business credit disallowed under the limit discussed above is available as a carryover (*i.e.*, three years back and 15 forward).[314]

Under a special rule (which permits the investment credit to offset tentative AMT to a limited extent), however, to the extent general business credit is attributable to the transition-rule and carryover investment credits, the general business credit is limited to the greater of:

(i) the excess of the regular tax (as reduced by §§27, 28 and 29 credits) over 75% of tentative AMT for the taxable year, but not to exceed the allowable portion of the taxpayer's net regular tax liability for the taxable year,

(ii) 25% of the taxpayer's tentative AMT for the taxable year.[315]

Note, however, that the general business credit, to the extent it is attributable to the transition-rule and carryover investment credits, will offset the regular tax even though no §§28 and 29 credits were allowable due to the tentative AMT limitation. This is because these investment tax credits are also allowable against tentative AMT.

Note also that, if net AMT liability has been reduced to 10% of tentative AMT computed under §55(b)(1)(A) without regard to the net operating loss deduction and the AMT foreign tax credit, the transition-rule and carryover investment credit will not be allowed to reduce the regular tax or tentative AMT.

(v) Finally, the 1986-TRA enacted minimum tax credit (§53) is applied against regular tax but only to the extent the regular tax, (as reduced by §§27, 28, and 29, and the general business credit) exceed tentative AMT for the taxable year.[316] Note that the minimum tax credit is cumulative, *i.e.*, it includes the minimum tax credits disallowed in prior years under the limit discussed above.[317]

C. *Collateral Rules*

1. *Minimum Tax Credit*

a. *General*

The philosophical basis of the add-on minimum tax, which applied to all taxpayers prior to the Tax Reform and Fiscal Responsibility Act of 1982 and to corporate taxpayers only prior to the TRA 1986, was that tax preferences and tax incentives were bad per se, and therefore, taxpayers using them should pay a penalty tax on them. The philosophical basis of the alternative minimum tax (which now applies to all taxpayers) on the other hand, is that tax preferences and tax incentives are not evil per se, but a taxpayer should not be permitted to use them to reduce his its liability below a minimum standard. Prior to the 1986 Act, this minimum standard was applied on an annual basis: a taxpayer paid the minimum tax if within any taxable year the use of tax preferences or tax incentives reduced the regular tax liability below the minimum standard. The minimum standard was abandoned in other years in which the regular tax was higher than the minimum standard with no offsetting adjustments or credits for the minimum tax paid in a prior year. This application of the minimum standard on an annual basis often resulted in inequities because, due to the imposition of AMT, the taxpayer did not get the amount of regular tax benefit from items of tax preference which he would have obtained if those items had not received preferential treatment in the first place. To eliminate this inequity, the drafters of the 1986 Act made two important changes to the AMT structure: they introduced (i) the adjustment mechanism (§§56 and 58), and (ii) the minimum tax credit. It was seen earlier how the adjustment mechanism provides compensating adjustments to AMTI in subsequent years. The minimum tax credit similarly compensates the taxpayer for the loss of regular tax benefit in an AMT year by reducing the regular tax in subsequent years when the taxpayer is not in an AMT position.

b. *Operative Rules*

When a taxpayer is subjected to minimum tax liability in any taxable year, the amount of adjusted net AMT paid in that year is available as a credit against its regular tax liability in future years. This credit, however, will not reduce the regular tax below the tentative AMT in any year. Note that the entire net AMT liability for a taxable year may not be available as a credit. Under §53(b), if a portion of net AMT liability for a taxable year is attributable to the depletion preference, exempt interest preference, or to the preference for charitable contributions of appreciated property, such portion is not available as a credit.[318] Thus, in an AMT year, a taxpayer is required to make two distinct AMT computations: one taking into account all the items of adjustment (within the meanings of §§56 and 58) and preferences (within the meaning of §57), and another as if the only items of preference were the depletion deduction, the exempt interest exclusion and the deduction for charitable contribution of appreciated property. The amount of net AMT available as a credit is then obtained by subtracting the result of second computation from the result of first.

In any taxable year, the amount of minimum tax credit that may be applied to reduce regular tax is limited, like all other nonrefundable credits, to the excess of the regular tax (as reduced by all other nonrefundable credits) over tentative AMT.[319] Thus, the minimum tax credit is available only after all other nonrefundable credits have been utilized and there remains an excess of the regular tax over tentative AMT. The amount of minimum tax credit that is not utilized against regular tax because of the tentative AMT

[311] §38(c)(1).
[312] §38(c)(2).
[313] *Id.*
[314] §39(a).
[315] §38(c)(3).
[316] §53(c).
[317] §53(b).
[318] §53(d)(1)(B).
[319] §53(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

limit is carried over to the following taxable year, is aggregated, and becomes part of the minimum tax credit for that year.[320] The minimum tax credit may be carried forward indefinitely, however, it may not be carried back.[321]

2. Apportionment of Differently Treated Items

In the case of a regulated investment company or a real estate investment trust, items of tax preference and other items (*e.g.*, items of adjustment, credits) which are treated differently for regular tax purposes, are required to be apportioned between such company or trust and its shareholders or holders of beneficial interests in accordance with the regulations to be prescribed by the Secretary.[322]

In the case of a common trust fund, the differently treated items are required to be apportioned among the participants on a pro rata basis.[323]

3. Tax Benefit Rule

The Conference Report states that "Since the regular and minimum taxes generally are computed separately, relief from the minimum tax under the tax benefit rule is not appropriate solely by reason of the fact that a taxpayer has received no benefit under the regular tax with respect to a particular item." [324] The statute, nevertheless, leaves it within the discretion of the Secretary to provide, by regulations, for the adjustment of differently treated items in cases where the tax treatment accorded such items shall not result in a reduction of the taxpayer's regular tax for any taxable year.[325]

4. Short Taxable Year

Section 443(d) provides rules for dealing with short taxable years for purposes of AMT. Essentially, §443(d) requires annualization of both the AMTI and the tentative minimum tax to determine the minimum tax liability of a taxpayer for a short taxable year. The annualization is accomplished by multiplying the AMTI for the short period by 12 and dividing it by the number of months in the short taxable year. The tentative minimum tax is similarly annualized.

5. Possessions Corporations

Possessions corporations are not subject to AMT on income with respect to which a credit under §936 is claimed.[326] This result is achieved by excluding from AMTI the amounts with respect to which the requirements of subparagraphs (A) or (B) of §936(a)(1) are met.

6. Estimated Taxes

Section 701(d) of the 1986 Act amended §6154(c), §6425(c)(1), and 6655(f) to provide that corporate taxpayers must pay estimated taxes on their potential §55 tax liabilities.

[320] §53(b).
[321] *Id.*
[322] §59(d)(1)(A).
[323] §59(d)(1)(B).
[324] Conference Report at II-262.
[325] §59(g).
[326] §59(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 34

COMPUTATION OF CORPORATE TAXABLE INCOME AND AMOUNT OF TAX

Samuel M. Maruca, Esq.
Silverstein and Mullens
Washington, D.C.

I. Inclusion of Contributions in Aid of Construction

A. Background

Public utilities providing water and sewage disposal traditionally have obtained a substantial amount of the capital necessary to construct facilities through contributions in aid of construction. The concept originated in a line of early Board of Tax Appeals cases in which potential customers provided a utility with money or property necessary to extend service lines to include them.[1] These courts held that the contributed amounts did not constitute taxable income to the utilities.

In 1958, the Service announced that it would follow the early cases with respect to regulated utilities.[2] In 1975, however it revoked the 1958 ruling.[3] Congress enacted §118(b) in response to this revocation.[4]

Congress considered §118(b) necessary for several reasons. First, Congress expected that the IRS ruling would increase substantially the tax liability of the utilities that had previously treated contributions in aid of construction as nontaxable contributions to capital, resulting in increased utility rates to customers. Since utility rate increases must be approved by public utility commissions, the working capital of the utilities would be substantially reduced, resulting in delays in furnishing service and curtailment of service expansion. Moreover, the immediate inclusion of these contributions in income would cause a mismatching of income and related expense, since the utility would have an increase in income in the year the contributions were received, but most of the expenditures attributable to those facilities would not arise until subsequent years.[5]

B. Repeal of Exclusion for Contributions

The 1986 TRA repeals the provision allowing a corporate regulated public utility to exclude from gross income contributions in aid of construction, or any other contribution by a customer or potential customer.[6]

The Ways and Means Committee Report (the "House Report") indicates that the repeal of the exclusion for contributions in aid of construction is intended to be very broad.[7] If the receipt of property or money by the utility causes the transferor to be favored in any way (*e.g.*, if the contribution results in earlier provision of services to the contributor than would have been the case absent the contribution), the utility must take such property or money into income. The House Report at 644 states that whether the utility has a policy, stated or unstated, requiring or encouraging contributions is irrelevant. Moreover, preferential service to the contributor is not required. For example, where housing developers but not individual homeowners are required to transfer property as a condition of service, the utility must include in gross income property transferred by the developers.

With respect to the degree of benefit that will trigger inclusion, the House Report contemplates that inclusion is required when the contributor derives any benefit for the property that will receive the services. This would be the case if, for example, a builder transferred property to secure services for a house he was paid to build, even though he never had an ownership interest in the house.[8]

C. Effective Date

The repeal is generally effective for contributions received after December 31, 1986, in taxable years ending after such date.[9]

II. Changes in Dividends Received Deduction

A. Background

Under Code §243, dividends received by a corporate stockholder are largely deductible. The purpose of this provision is to relieve corporate income distributed to corporate shareholders from a second tax at the corporate level.

Under pre-1986 TRA law, 85% of dividends received from outside an affiliated group are deductible. §243(a)(1).

---

[1] *See, e.g., Great Northern Railway Co. v. Comr.*, 8 B.T.A. 225, appeal dismissed, 40 F.2d 372 (8th Cir. 1930); *Texas & Pacific Railway Co v. Comr.*, 9 B.T.A. 365 (1927); *Atlantic Coast Line Railway Co. v. Comr.*, 9 B.T.A. 1193 (1928).

[2] Rev. Rul. 58-555, 1958-2 C.B. 25.

[3] Rev. Rul. 75-557, 1975-2 C.B. 33.

[4] §118 was amended in 1978 so as to include gas and electric utilities. *See* P. L. No. 95-600, §364(a).

[5] *See* S. Rept. No. 938, 94th Cong., 2d Sess. at 435 (1976).

[6] Act §824(a); Code §118(b).

[7] *See generally* H. Rept. No. 426, 99th Cong., 1st Sess. at 644 (1985)(hereinafter "House Report").

[8] *Id.*

[9] Act §824(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

For certain public utility preferred stock, the deduction is somewhat reduced.[10] Moreover, the Code generally limits the dividends received deduction to 85% of taxable income (computed without regard to the dividends received deduction and certain other items).[11]

There are a number of special rules applicable with respect to the dividends received deduction. Under §246A, the deduction is reduced where portfolio stock (generally, stockholdings of less than 50% of total voting power and less than 50% of value) is directly financed by indebtedness. This limitation applies for purposes of §245 (relating to dividends received from certain foreign corporations) as well as §§243 and 244.[12]

A second special rule disallows the deduction if the shareholder holds the stock for less than 45 days (90 days in the case of certain preferred stock), but only if the shareholder disposes of the stock.[13] The disposition requirement may result in retroactive disallowance of the deduction when the shareholder disposes of the stock after the close of the taxable year of receipt of the dividends. The holding period is computed without regard to periods in which the shareholder's risk of loss is reduced (where, for example, the shareholder has an option to sell substantially identical stock).[14]

B. TRA 1986 Amendments

1. Reduction in Dividends Received Deduction

The 1986 Act reduces the corporate dividends received deduction from 85% to 80%.[15] This reduction applies for purposes of the general rule of §243(a)(1), the deduction for dividends as public utility preferred stock under §244, the §246(b)(1) limitation as aggregate allowable dividends received deductions (now capped at 80%), the debt-financed portfolio stock rules under §246A and the limitation on the deduction for dividends received by a life insurance company under §805(a)(4)(B).

2. Technical Corrections to 1984 Act Provisions

The 1986 Act clarifies the §246A rules insofar as they apply to the dividends received deduction for dividends received from foreign corporations. First, the Act specifies that dividends received from wholly-owned foreign subsidiaries (§245(b)) and from foreign sales corporations ("FSCS")(§245(c)) are not subject to the limitation.[16] Second, the Act clarifies that the limitation must be applied before determining, under §246(a)(1) or (2), the ratio of the percentage of dividends that is deductible (which ratio is a function of the percentage of the payor's gross income that is effectively connected with a United States trade or business).[17]

The Senate Finance Committee Report contains the following example of how the limitation is to be applied:

Example: Assume that 70% of a domestic corporation's purchase price for portfolio stock of a foreign corporation described in §245(a) is debt financed. Assume further that 60% of that foreign corporation's gross income is effectively connected with the conduct of a trade or business in the United States. In the absence of §246A, the domestic corporation generally would be entitled to deduct 51% (85% times 60%) of any dividend received from the foreign corporation. Under §246A [as amended], the domestic corporation generally is entitled to deduct only 15.3% ((30% times 85%) times 60%) of any such dividend.[18]

The 1986 TRA amends §246(c)(1)(A) to provide that no dividends received deduction is allowable unless the taxpayer meets the 45 day holding period (90 days in the case of preference stock) requirement by the 45th day (90th day in the case of preference stock) following the ex-dividend date.[19] The House Report notes that the correction is not intended to require that the holding period be met by the date of receipt of the dividend, provided the stock is held for at least 45 days.[20] The Act also amends §246(c)(4) such that the rules requiring reduction of the taxpayer's holding period when its risk of loss is diminished will apply for all purposes of §246(c).[21] However, the Ways and Means Committee clarified that the 1984 Act did not modify the principle that an "out-of-the-money" call option that affords no protection against loss will not result in disallowance of the deduction.[22] The amendments made to §246 by Act §1804(b)(1)(A) and (B) apply to stock acquired after March 1, 1986. Act §1804(b)(1)(C).

C. Effective Dates

The reduction in the dividends received deduction is effective for dividends received or accrued after December 31, 1986, in taxable years ending after that date. The reduction in aggregate allowable deductions as a percentage of gross income under §246(b)(1) applies in taxable years beginning after December 31, 1986.[23]

III. Nondeductibility of Stock Redemption Expenses

A. Background

Code §162 allows as a deduction all "ordinary and necessary" expenses paid or incurred in a trade or business. According to some corporate taxpayers, this general provision includes amounts paid in connection with the redemption of stock for the purpose of discouraging takeover attempts ("greenmail" payments), and amounts paid to a shareholder or former shareholder in exchange for a promise not to purchase stock in the corporation for a specified or indefinite period of time (a "standstill" agreement).

The validity of deductions for the repurchase of stock by a corporation is uncertain. The courts have adopted

[10] *See* Code §244.
[11] *See* Code §246(b)(1).
[12] §246A(a).
[13] §246(c)(1) and (2).
[14] §246(c)(4).
[15] Act §611.
[16] Act §1804(a)(1).
[17] Act §1804(a)(2).
[18] S. Rept. No. 313, 99th Cong, 2d Sess. at 905 (1986) (hereinafter "Senate Report").
[19] Act §1804(b)(1)(A).
[20] House Report at 890.
[21] Act §1804(b)(1)(B).
[22] House Report at 890, citing Rev. Rul. 80-238, 1980-2 C.B. 96.
[23] Act §611(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

conflicting positions on the point.[24] However, the Supreme Court held that costs incurred in appraising minority shares in a purchase transaction are nondeductible capital expenditures.[25]

B. Disallowance of Deductions

Act §613(a) adds new §162(l) which provides that no deduction otherwise allowable shall be allowed for any amount paid or incurred by a corporation in connection with the redemption of its stock. Such amounts must be capitalized. This general rule does not apply to interest under §163 or to the deduction for dividends paid (within the meaning of §561). §162(l)(2)(A). Also excluded are expenses incurred in connection with the redemption of stock by a regulated investment company ("RIC") that issues only stock redeemable on demand.[26] This provision applies to any amount paid or incurred after February 28, 1986, in taxable years ending after such date. Act §613(b).

Note: The exclusion of interest expense will enable the taxpayer to finance redemption expenses, even if it cannot deduct them any longer.

The legislative history of §162(l) indicates that the provision is intended to be very broad, but not limitless. The disallowance rule applies to, *inter alia,* (1) all expenditures incurred by a corporation or by the selling shareholders or any related person (*e.g.*, a subsidiary of the redeeming corporation) in a redemption; (2) premiums paid for the stock; and (3) legal, accounting, brokerage and similar fees.[27] The Conference Report cautions, however, that otherwise deductible payments having no nexus with the redemption (other than temporal coincidence or shared general circumstances) will still be deductible.[28] Thus, a payment in discharge of other contractual obligations, such as compensation to an employee-shareholder or a payment in settlement of litigation, is deductible to the extent it is "clearly established" that the payment is not consideration for the stock or an expense of the redemption.[29]

The Conferees anticipated that the Service would scrutinize transactions temporally proximate but not directly related to a redemption. Specifically, an allocation of expenses between the redemption and the unrelated transaction is to be respected only if supported by all of the facts and circumstances. All payments made pursuant to "standstill" agreements, however, are to be considered related to any redemption of the payee's stock, and hence nondeductible.[30]

IV. Special Treatment for Capital Gains Repealed

A. Background

Pre-1986 law limited the tax payable in the case of a corporation having net long-term capital gain in excess of net short-term capital loss (*i.e.*, "net capital gain" as defined in §1222(11)).[31] Under the "alternative tax for corporations" (§1201), a corporation with net capital gain is subject to tax at (1) the regular corporate rate on taxable income reduced by the amount of the net capital gain, plus (2) 28% of the net capital gain. The alternative tax applies only if such tax is less than the regular tax.

B. Repeal of Corporate Capital Gains Rate Differential

The 1986 TRA repeals the favored treatment of corporate net capital gains accorded by the alternative tax by conforming the alternative rate provided in §1201(a)(2) to the top marginal rate on corporate income (34% under §11, as amended by the Act.) [32] For this purpose, the 5% surtax on corporate taxable income in excess of $100,000 is disregarded. Accordingly, even though corporate taxable income attributable to net capital gain could be subject to the regular tax at rates in excess of 34%, no special treatment is available.

Although the Act eliminates the rate differential for corporate net capital gains, the pre-existing statutory structure is retained intact. According to the Conference Report, the structure was retained "to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase." [33]

C. Effective Date and Transitional Rules

The amendments to §1201(a) apply to taxable years beginning after December 31, 1986.[34]

The Act provides a special transitional rule for taxable years that begin before January 1, 1987, and end in 1987. Under this rule, net capital gains is the sum of 28% of the lesser of: (1) pre-January 1, 1987 capital gain or net capital gain for the tax year, plus (2) 34% of the excess of net capital gain for the tax year over the amount of net capital gain taken into account under (1), *supra.*[35]

The Act permits §631(a) elections (relating to the special election to treat gain on cut timber as §1231 gain) for pre-January 1, 1987 taxable years to be revoked for any taxable years ending after December 31, 1986, without prejudice to further elections (*i.e.*, in the event a rate differential is reintroduced).[36]

V. Corporate Rate Reductions

A. Pre-TRA 1986 Rates

Corporate taxable income for taxable years beginning in 1982 and thereafter, but before the 1986 TRA effective date, is subject to tax in accordance with the following schedule:

[24] *Five Star Manufacturing Co. v. Comr.*, 355 F.2d. 724 (5th Cir. 1966) with *Proskauer v. Comr.*, 46 T.C.M. 679 (1983).
[25] *See Woodward v. Comr.*, 397 U.S. 572 (1970); *U. S. v. Hilton Hotels Corp.*, 397 U.S. 580 (1970).
[26] §162(1)(2)(B).
[27] Senate Report at 223.
[28] H.R. Rept. No. 841, 99th Cong., 2d. Sess. at II-169 (hereinafter "Conf. Rep.").
[29] *Id.*
[30] *Id.*
[31] §1201(a).
[32] Act §311(a); Code §1201(a).
[33] Conf. Rep. at II-107.
[34] Act §311(c).
[35] Act §311(d)(1).
[36] Act §311(d)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Taxable Income	*Rate*
$0 — $25,000	16%
$25,001 — $50,000	19%
$50,001 — $75,000	30%
$75,001 — $100,000	40%
over $100,000	46%

For taxable years beginning after December 31, 1983, taxable income in excess of $1,000,000 is subject to an additional tax equal to the lesser of (1) 5% of the excess over $1,000,000 or (2) $20,050. This additional tax completely eliminates the benefit of graduated rates for corporations having taxable income in excess of $1,405,000.

B. Rate Reduction

TRA 1986 substantially reduces the tax rate applied to corporate taxable income. Under Act §601(a), amending §11(b), such income will be subject to tax at the following rates:

Taxable Income	*Rate*
$0 — $50,000	15%
$50,001 — $75,000	25%
more than $75,000	34%

Corporate taxable income in excess of $100,000 is subject to tax equal to the lesser of (1) 5% of the excess over $100,000 or (2) $11,750, resulting in a complete phaseout of the benefit of graduated rates in the case of a corporation with taxable income of $335,000 or more. Amended §11(b)(flush language).

Observation: By virtue of the graduated rate structure established by the Act, *supra,* the tax on a C corporation with taxable income of $100,000 will be $5,750 less than the tax on $100,000 of income where the assets are held directly or in an S corporation (assuming tax at the maximum effective rate of 28% on the entire $100,000).

C. Effective Date and Transitional Rule

The corporate rate reduction applies to taxable years beginning on or after July 1, 1987. For taxable years that include that date, the blended rate rules of §15 apply. Act §601(b).

Example: Corporation X has a fiscal year ending April 30. For its fiscal year ending April 30, 1988, Corporation X has taxable income of $200,000. Under pre-1986 TRA rates, Corporation X's tax liability would have been $72,250. Under the new rate structure, the tax liability is $61,250. Applying the blended rate rules of §15, Corporation X's tax liability for its fiscal year ending April 30, 1988, is $63,088 ((61/365 x $72,250) plus (304/365 x $61,250)).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 35

REVISION OF NOL AND CREDIT CARRYOVER RULES

Donald B. Reynolds, Jr., Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. Summary of TRA Changes

The Tax Reform Act of 1976 substantially revised the limitations on net operating loss ("NOL") carryforwards that apply, under §382, to transactions involving loss corporations. Although Congress adopted a 1978 effective date for the revisions to §382, it repeatedly extended the effective date. At the same time, §382 became the subject of extensive study and critical analysis by Congressional staff and professional tax groups. These efforts culminated in Act §621 of TRA 1986, which has adopted another comprehensive revision of §382.

The underlying theory of revised §382 is that, following a substantial change in ownership of a loss corporation (*i.e.*, more than a 50 percentage point change in stock ownership), its NOL should be utilized to the same extent and at the same rate as if no restructuring had occurred. In attempting to incorporate this principle into post-TRA 1986 §382, however, Congress produced a complex set of rules. After summarizing the state of pre-TRA 1986 law, this Chapter will review the latest Congressional effort to improve and refine §382 of the Code.

B. Pre-TRA 1986 Law

Section 172 of the Code establishes a basic exception to the general principle that federal income tax is determined and assessed on an annual basis. That is, in order to grant taxpayers a measure of relief in certain circumstances when their profitability fluctuates, §172 generally allows taxpayers to carry net operating losses back to the three taxable years preceding the loss and then forward to each of the 15 years following the loss.

As a general proposition, the Code preserves a corporation's tax attributes, including its NOL carryforwards and carrybacks, as long as the corporation continues its legal identity. Section 381 of the Code establishes rules governing the extent to which an acquiring corporation shall succeed to the tax attributes of another corporation following certain corporate transactions. Under these rules, NOL carryforwards may be liberally assumed by the acquiring corporation.[1] Section 381 applies to the liquidation of an eighty-percent-controlled subsidiary under §332, as well as to A, C, D, F, and G reorganizations.[2] While §381 generally allows the acquiring corporation to assume NOL carryforwards, the acquiring corporation may not carryback the NOL of the acquired corporation except in an F reorganization.[3]

Notwithstanding the general rules of §381, several statutory and judicial principles have restricted the availability of NOL carryovers in corporate acquisitions. These limitations, as they existed under pre-TRA 1986 law, are briefly described below.

1. Pre-TRA §382(a): Purchases

Pre-TRA §382(a) potentially limited NOL carryovers in the case of a substantial purchase of corporate stock. Basically, §382(a) precluded a corporation from carrying over its NOL in circumstances where (i) there was an increase of at least 50 percentage points in the stock ownership of the corporation's 10 largest stockholders during a two-year period (the "lookback period"); (ii) the increase occurred as a result of a "purchase";[4] and (iii) the loss corporation failed to continue to conduct a trade or business substantially similar to the trade or business it conducted before the change in stock ownership.[5]

If the three-part test of §382(a) was satisfied, the loss corporation's NOL carryforward was disallowed entirely. In contrast to the rules in §382(b) applicable to reorganizations, §382(a) did not provide for the carryforward of a reduced NOL.

2. Pre-TRA §382(b): Reorganizations

Pre-TRA §382(b) governed the availability of NOL carryforwards in tax-free A, C, F, and certain D and G reorganizations. The underlying premise of §382(b) was that a prescribed continuity of interest level must be satisfied in order to preserve the NOL carryforwards of a loss corporation that was a party to a reorganization. Further, the limitations in §382(b) applied regardless of whether the loss corporation was the acquired or acquiring corporation. Basically, §382(b) restricted the availability of NOL carryforwards if, pursuant to one of the reorganizations specified

[1] *See* §381(c)(1).
[2] §381(a).
[3] §381(b)(3).
[4] Although pre-TRA §382(a)(4) defined the term "purchase" as an acquisition in which the transferee acquired a cost basis in the acquired stock, the 50 percentage point change in ownership also could be triggered by an increase in stockholdings resulting from a redemption. *See* §382(a)(1)(B)(ii). Citations to §382 as it existed prior to the TRA 1986 amendments will be referred to as "pre-TRA §382."
[5] Each of the three separate requirements of pre-TRA §382(a) is the subject of an extensive body of law provided by regulations and judicial decisions. *See* 27 T.M., *Net Operating Losses — Sections 381, 382 and 269.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

above, the former stockholders of the loss corporation received or retained less than a 20% stock interest in the surviving corporation. Unlike §382(a), §382(b) did not incorporate a continuity of business requirement because, as a tax free reorganization, a transaction subject to §382(b) would fall subject to the continuity of business enterprise requirement imposed by the regulations under §368.[6]

If the 20% minimum ownership test was not satisfied, the loss corporation's NOL carryforward was reduced by 5% for each 1% difference between the 20% minimum standard and the actual interest received by the loss corporation's shareholders.[7]

3. Section 269: Tax Avoidance Limitation

Section 269 of the Code authorizes the Service to disallow any deduction, credit or other allowance if a corporation is acquired and the acquiring party's principal purpose for the acquisition is the evasion or avoidance of federal income tax. Section 269 potentially applies to both an acquisition of a controlling interest in a corporation by any person, as well as an acquisition of corporate assets by another corporation.[8] Unlike §382, §269 requires an evaluation of the subjective intent of the acquiring party, *i.e.*, whether the party's principal purpose for the acquisition was evasion or avoidance of tax. Because §269, unlike §382, does not incorporate any quantitative guidelines, §269 provides the Service with an open-ended means of challenging NOL carryforwards and other favorable tax attributes that may be acquired in a corporate transaction. Further, once the Service has determined that the principal purpose for an acquisition is tax avoidance, the disallowance of NOL carryovers and other items is presumptively correct.[9]

As might be expected given the somewhat broad and imprecise reach of §269, an extensive body of case law has developed under that code section.[10]

4. Libson Shops Doctrine

In *Libson Shops v. Koehler*,[11] the Supreme Court reviewed the merger of sixteen commonly-owned operating corporations into a seventeenth commonly-owned corporation which had previously managed the other sixteen corporations. Three of the operating corporations had incurred pre-merger losses, and continued to incur losses in the year following the merger. The surviving corporation deducted the NOL from the income generated by the assets of several of the other corporations in the year following the merger. Applying §122 of the 1939 Code, the Court held that the pre-merger NOL could not be carried over to the first taxable year of the surviving corporation. In reaching this conclusion, the Court applied a continuity of business enterprise theory and relied upon the fact that the business producing the postmerger income was not substantially the same business that incurred the NOL.

In the years following the Supreme Court decision, there has been dispute over the extent to which the *Libson Shops* doctrine survived as an operative principle of law under the 1954 Code.[12] Although the legislative history of The Tax Reform Act of 1976 stated that *Libson Shops* was not to be considered a controlling authority for years governed by the 1976 amendments to §382,[13] this statement is ambiguous when applied to the 1954 Code version of §382 inasmuch as the 1976 amendments never became controlling law.

5. Consolidated Return Regulations

In addition to the rules described above that applied to corporate acquisitions, the consolidated return regulations have imposed independent limitations that restrict the availability of NOL carryforwards. The regulations provide that when an acquired corporation becomes a member of an affiliated group, the acquired corporation's pre-acquisition NOL carryforward is subject to the separate return limitation year ("SRLY") rules. The effect of the SRLY rules is to allow a consolidated group to deduct the pre-consolidation losses of the acquired corporation only against the acquired corporation's post-consolidation income.[14] The SRLY rules also provide that an acquired corporation's "built-in" losses, as defined in Regs. §1.1502-15, may be deducted only against its post-acquisition income. For these purposes, the regulations define built-in losses as losses that accrue economically before the acquisition but are not realized, for tax purposes, until after the acquisition.

The consolidated return regulations also establish restrictions applicable if there is a change in ownership of the common parent's stock equal to more than 50% of the value of such stock. These limitations, known as the consolidated return change of ownership ("CRCO") rules, require that NOL carryforwards of the group that arise before the change in ownership only may offset income earned by the pre-acquisition members of the group.[15]

6. Tax Reform Act of 1976

As part of the Tax Reform Act of 1976, Congress adopted a comprehensive revision of the statutory limitations on NOL carryforwards. Although the statutory revision retained the formal dichotomy between §382(a) and §382(b), Congress attempted to provide for more uniformity between the two sets of rules. Although Congress originally adopted a 1978 effective date for the revised §382, it subsequently extended the effective date several times, most recently in the Tax Reform Act of 1984. Section 62 of the 1984 Act postponed the effective date until January 1, 1986.

[6] Regs. §1.368-1(d).

[7] Reorganizations involving corporations that were owned substantially by the same persons in the same proportion were exempted from §382(b). *See* pre-TRA §382(b)(3). This exception is based upon the theory that continuity of interest will exist in these transactions by reason of the common stock ownership.

[8] §269(a).

[9] *See H. F. Ramsey Co., Inc. v. Comr.*, 43 T.C. 500, 516 (1965), nonacq., 1965-2 C.B. 7.

[10] For a review of these cases, *see* 27 T.M., *Net Operating Losses — Sections 381, 382 and 269.*

[11] 353 U.S. 382 (1957).

[12] *Compare Maxwell Hardware Co. v. Comr.*, 343 F.2d 713 (9th Cir. 1965) (holding that *Libson Shops* did not survive under the 1954 Code) *with* Rev. Rul. 63-40, 1963-1 C.B. 46 (stating that *Libson Shops* may apply in certain instances). For a general discussion of *Libson Shops*, *see* 27 T.M., *Net Operating Losses — §381, 382 and 269.*

[13] *See* S. Rep. No. 938, 94th Cong., 2d Sess. 206 (1976).

[14] *See* Regs. §1.1502-21(c).

[15] *See* Regs. §1.1502-21(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

II. Overview

A. *Preliminary Legislative Proposals*

Over the past several years, the NOL carryforward rules have been the subject of considerable study and debate. In September, 1983, the staff of the Senate Finance Committee proposed, as part of its preliminary report on the simplification of Subchapter C, a series of extensive amendments to §382.[16] The underlying premise of the Finance Committee staff's preliminary proposal was that following a change in ownership, a loss corporation (or its successor) should be entitled to use the NOL carryforwards to the same extent as the loss corporation would have used them had no acquisition taken place and had the loss corporation invested its assets in activities generating taxable income. Having identified this general principle, the staff proposal proceeded to describe two sets of limitation rules. One rule (the "purchase" rule) would apply to stock purchases, redemptions, and certain qualified acquisitions (*i.e.*, acquisitions resulting in a carryover basis) to the extent the consideration did not consist of the acquiring corporation's stock. The second rule (the "merger" rule) would apply to qualified acquisitions to the extent the consideration consisted of the acquiring corporation's stock, as well as to transactions in which an ownership change resulted from the issuance of new stock in exchange for cash or other property.

Commentators generally agreed with the "neutrality" principle adopted in the preliminary proposal of the Finance Committee staff (*i.e.*, that NOL carryovers should be available following an acquisition to the same extent as if no acquisition had occurred). There was considerable opposition, however, to the specific purchase and merger rules proposed by the staff.[17] The opposition generally focused on the complexity of the separate rules.

In light of the objections to the preliminary Finance Committee staff proposal, the final report prepared by the staff proposed a single rule which would limit the availability of NOL carryforwards in any case of a 50 percentage point change in ownership of the loss corporation. The staff, however, attempted to retain a "neutrality" principle ensuring that after a change in ownership, the loss corporation's NOL carryforward would be limited to the same use that would have been available to the loss corporation had no change in ownership occurred. To achieve this result, the Finance Committee staff made certain assumptions about the rate at which a typical loss corporation absorbs its NOL by offsetting it against taxable income. Based on statistics provided by the Joint Tax Committee, the staff assumed that the long-term federal rate established under §1274 of the Code provided an appropriate absorption rate. Thus, under the final staff proposal, the annual limitation on NOL carryforwards generally would be limited to an amount equal to the absorption rate (*i.e.*, the long-term federal rate) times the value of the loss corporation at the time of the change in ownership.[18]

B. *Final Legislation*

Act §621 of TRA 1986 enacted an amendment to §382 which draws, in large part, upon the Final Report of the Senate Finance Committee staff.[19] Thus, the Act incorporated a single rule limiting NOL carryforwards which applies in the case of any substantial change in the ownership of a loss corporation. Further, TRA 1986 adopted an absorption limitation which fixes, on an annual basis, the amount of earnings that may be offset by the loss corporation's NOL. This annual limitation is calculated by applying a rate of return against the value of the loss corporation at the time of the change in ownership. TRA 1986 established the federal long-term tax-exempt rate as the controlling rate for calculating the absorption limitation. In addition to the absorption limitation, TRA 1986 also imposes a general disallowance of NOL carryforwards if a two-year continuity-of-business enterprise standard is not met.

Under the rules enacted by TRA 1986, §269 continues to be available to the Service as an independent means of challenging NOL carryforwards following corporate acquisitions. Further, the legislative history states that the SRYL and CRCO limitations will continue to apply notwithstanding the amendment to §382. TRA 1986, however, overrules the *Libson Shops* doctrine for years governed by post-TRA 1986 §382. Finally, the 1986 Act generally repealed the amendments to §382 enacted by the Tax Reform Act of 1976. Other than in the case of special situations covered by transitional rules, the repeal of the 1976 amendments is effective retroactively to January 1, 1986. Consequently, the repeal by TRA 1986 prevents the 1976 amendments from becoming controlling law for the portion of 1986 preceding the date of enactment of the 1986 Act.[20]

C. *Effective Dates*

The 1986 amendments to §382 generally apply if an "ownership change," as defined in the statute, occurs with respect to a loss corporation after December 31, 1986. Act §621(f). The December 31, 1986 effective date is subject, however, to a number of transitional rules and special exceptions.

III. Detailed Analysis

A. *Ownership Change*

As noted above, TRA 1986 establishes a single set of rules in §382 for testing all changes in ownership of a loss corporation, regardless of whether the change occurs by

[16] *See* Staff, Committee on Finance, 98th Cong., 1st Sess., *The Reform and Simplification of the Income Taxation of Corporations* 95 (Comm. Print 1983). For other detailed studies proposing changes in §382, *see* American Law Institute, *Federal Income Tax Project: Subchapter C Proposals on Corporate Acquisitions and Dispositions* (1982); American Bar Association Tax Section Committee on Corporate Stockholder Relationships, Legislative Recommendation 1985-1.

[17] *See* Staff, Committee on Finance, 99th Cong., 2d Sess., *The Subchapter C Revision Act of 1985*, 47 (Comm. Print 1985) at pp. 8, 69-70 (hereafter cited as the "Final Report").

[18] Final Report, *supra*, at 71-72.

[19] Act §621(a) of TRA 1986 (P.L. 99-514) contains the amendments to Code §382. Throughout this chapter, all citations to TRA 1986 are cited to §382 as it is amended by the Act. The citations refer to post-TRA §382 as "§382 or post-TRA §382."

[20] *See* H.R. Rep. No. 841 (Vol. II), 99th Cong., 2d Sess. pp. II-194-195 (1986) (Conference Report).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

reason of a purchase or a tax-free reorganization. Both the House and Senate bills adopted this approach, although a number of the definitional terms were modified during the course of the legislative process.[21] As enacted, post-TRA §382 will generally apply in the event of an "ownership change" in a loss corporation. The Act provides that the determination of whether an ownership change has occurred must be made after any "owner shift involving a 5% shareholder" and any "equity structure shift." [22]

Under post-TRA §382(g), an ownership change generally occurs when the percentage of stock (based on value) owned by one or more 5% shareholders in a "new loss corporation" increases by more than 50 percentage points over the lowest percentage of stock held by such stockholders, at any time during the "testing period," in an "old loss corporation" (or a predecessor).[23] An "old loss corporation" refers to a corporation which undergoes an ownership change and which was a loss corporation before the change. Code §382(k)(2). A "new loss corporation" refers to a corporation that is a loss corporation after an ownership change. The same corporation may be treated as an old loss corporation and a new loss corporation (*e.g.*, in the case of an owner shift involving a 5% shareholder that results from a stock purchase).[24]

Comment: Because the limitations of post-TRA §382 apply only after certain ownership changes (whether by reason of a purchase or reorganization), the Act should not impose any additional limitations upon the ability of a loss corporation to purchase a profitable business and offset its NOL against the income of the profitable assets.

For purposes of evaluating ownership changes, the testing period generally is the three-year period preceding the day on which any owner shift involving a 5% shareholder or any equity structure shift occurs.[25] Further, the Act defines a 5% shareholder as any person who holds 5% or more in value of the loss corporation's stock at any time during the testing period.[26] In this regard, the Act aggregates all less-than-five-percent shareholders and, effectively, treats them as one 5% shareholder.[27] Notwithstanding this aggregation rule, the Conference Report specifies that stock sales by less-than-five-percent shareholders of a public corporation to other less-than-five-percent shareholders will not, by themselves, give rise to an ownership change.[28]

As noted above, the definition of "ownership change" turns upon increases in the *value* of the loss corporation's stock held by 5% shareholders. In this regard, the Act provides that, except as provided in regulations to be promulgated by the Treasury, changes in proportionate stock ownership resulting from fluctuations in the market value of stock shall not be taken into account in determining whether an ownership change has occurred.[29] The Act also dictates that changes in the ownership of certain preferred stock are disregarded in determining whether an ownership change has occurred. For these purposes, TRA 1986 generally adopts the definition of preferred stock in §1504(a)(4) of the Code.[30] The Conference Report emphasizes, however, that the Treasury Department has broad authority to supplement this definition of preferred stock with additional regulations. These regulations presumably will implement the clear Congressional intent to overrule *Maxwell Hardware v. Comr.*[31] In that case, although the loss corporation's original shareholders retained common stock which represented more than 50% of the corporation's value, new shareholders received preferred stock entitling them to 90% of the corporation's earnings allocable to property contributed by the new shareholders. Under amended §382, the stock retained by the original shareholders in *Maxwell Hardware* would be ignored in determining whether an ownership change has occurred because such stock did not carry a significant right to participate in corporate earnings.[32]

1. *Owner Shift Involving a 5% Shareholder*

As noted above, a determination of whether an ownership change has occurred must be made after an "owner shift involving a 5% shareholder." Such an owner shift occurs when there is any change in the respective stock ownership of a corporation and such change affects the percentage of stock owned by a person who is a 5% shareholder before or after the change.[33] An owner shift involving a 5% shareholder may arise in any number of ways including the following:

(1) A taxable purchase of stock by a person who owns at least 5% of the corporation's stock either before or after the purchase;

(2) A sale or other disposition of stock by a person who holds at least 5% of the stock of the loss corporation either before or after the disposition;

(3) An exchange of property for stock in a transaction that satisfies §351 and results in a change in the percentage ownership of a 5% shareholder;

(4) A redemption that results in a change in the percentage ownership of a 5% shareholder;

(5) An exercise of a debt conversion privilege that results in a change in the percentage ownership of a 5% shareholder.

(6) An issuance of stock by a loss corporation that affects the percentage of stock ownership of a 5% shareholder.[34]

2. *Equity Structure Shift*

Under the Act, a determination of whether an ownership change has occurred also must be made following an "equity structure shift." An equity structure shift includes a reorganization within the meaning of §368 of the Code

[21] For example, the House bill referred to a change in ownership as a "trigger."
[22] *See* §382(g)(1).
[23] *Id.*
[24] *See* §382(k)(3).
[25] §382(i)(1). *See* III, B, *infra*, for a discussion of shorter testing periods.
[26] §382(k)(7).
[27] §382(g)(4)(A).
[28] Conference Report, *supra*, at II-176.
[29] §382(l)(3)(D).
[30] §382(k)(6)(A).
[31] 343 F.2d 713 (9th Cir. 1965).
[32] Conference Report, *supra*, at II-173.
[33] §382(g)(2).
[34] Conference Report, *supra*, at II-174.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(other than a divisive D or a G reorganization). Further, TRA 1986 authorizes the Treasury to issue regulations defining certain public stock offerings and "failed" reorganizations as equity structure shifts.[35] Following an equity structure shift, an ownership change will occur if, for example, the shareholders of the old loss corporation do not receive at least 50% of the stock in the surviving corporation (*i.e.*, the "new loss corporation").[36] This result will occur because if the shareholders of the old loss corporation receive less than 50% of the surviving corporation's stock, the original shareholders of the surviving corporation will experience an increase of more than 50% in their interest in the new loss corporation over their interest in the old loss corporation (which was zero).[37]

As illustrated by the discussion above, the determination of whether an equity structure shift causes an ownership change is similar to the evaluation made under pre-TRA §382(b). As is apparent, however, the Act, in effect increased the former 20% continuity of interest requirement to a more stringent 50% test.

3. Multiple Transactions

Because the determination of whether an ownership change has occurred requires that a 5% shareholder's ownership be evaluated for the preceding three years, the cumulative effect of ownership changes caused by a series of unrelated transactions clearly can result in an ownership change within the meaning of the statute. The Conference Report provides a number of examples illustrating this principle.[38]

Comment: Notwithstanding the Conferees' attempt to provide examples illustrating the effect of multiple transactions, the legislative history is silent with respect to the impact of "earn outs" and other escrow arrangements that commonly arise in corporate acquisitions. For example, if shares of an acquiring company are held in an escrow providing for their release to the target's shareholders upon the satisfaction of certain conditions (such as attaining a specified earnings level), it is not clear how the escrowed shares are evaluated in calculating whether an ownership change has occurred. The shares could be deemed to be owned by the target shareholders at the time they were placed in escrow or upon their release, if and when the escrow conditions are satisfied. Alternatively, the likelihood of the escrow conditions being satisfied theoretically could be viewed as having a bearing on whether the shares should be treated as owned by the target shareholders on the date the escrow is formed. Obviously, this latter principle may be difficult to apply in particular cases and may depend on future events that cannot be predicted with any certainty.

B. Testing Period

The applicable testing period for measuring whether an ownership change has occurred is, as noted above, generally three years. There are several significant exceptions to this general rule, however. First, if an ownership change occurs, the testing period applicable to a second ownership change does not begin before the day after the first ownership change. Thus, changes in stock ownership that caused the first ownership change do not count again and accumulate toward the 50% threshold that could trigger a second change. Moreover, a testing period does not begin before the first day of a taxable year in which the old loss corporation's NOL first arose. The theory underlying this rule is that taxable years ending before the tax attributes subject to §382 arose (*i.e.*, the NOL), should be disregarded for purposes of the testing period.[39]

C. Attribution and Other Rules Affecting Stock Ownership

Post-TRA §382 incorporates generally the attribution rules of §318, subject to several notable refinements.[40] Consequently, all evaluations of stock ownership required under §382 must be made with reference to certain shares that are treated as being constructively owned by a person. The variations from the basic rules of §318 are specified in §382(l)(3) and are explained in the Conference Report. The most noteworthy of these variations provides that stock owned by a corporation is attributed to all of its shareholders (and not just 50% shareholders) in proportion to their interests in the corporation. Moreover, except to the extent provided in regulations to be issued by the Treasury, stock attributed from a corporation to its shareholders will not be treated as owned by the corporation. The effect of this latter rule is generally to disregard intermediate corporations and evaluate changes in the stock ownership of a loss corporation with reference to the changes in the ultimate beneficial ownership of the corporation.

As explained previously, post-TRA §382 incorporates an aggregation rule which treats all less-than-five- percent shareholders of a corporation as a single 5% shareholder. This special aggregation rule applies with respect to shares owned actually or constructively by such less-than-five-percent shareholders.

Section 382 also provides that all transfers of stock resulting from gifts, death, divorce or separation are disregarded in determining whether an ownership change has occurred.[41] This exception should be particularly significant in the case of closely held corporations where, because of the concentration of ownership, the enumerated events (some of which are obviously uncontrollable) can lead to large shifts in stock ownership.

D. Limitations on NOL Carryforwards

Under post-TRA §382, upon the occurrence of an ownership change, two basic substantive provisions potentially limit the loss corporation's NOL carryforwards. First, if a continuity of business test is not satisfied, §382(c) disallows the carryforwards entirely. Second, if the continuity of business requirement is satisfied, the absorption limitation adopted by TRA 1986 will limit the rate at which the NOL may be utilized by the new loss corporation. *See* §382(b).

1. Continuity of Business Enterprise

Following an ownership change, a loss corporation's NOL carryforwards (along with certain built-in losses) are

[35] §382(g)(3).
[36] Conference Report, *supra*, at II-177 (*Example* 8).
[37] *See* §382(g)(1).
[38] Conference Report, *supra*, at II-178 to II-180.
[39] §382(i); Conference Report, *supra*, at II-185.
[40] §382(l)(3)(A); *see* Conference Report, *supra*, at II-180.
[41] §382(l)(3)(B).

disallowed entirely unless the continuity of business enterprise standards of Regs. §1.368-1(d) are satisfied throughout the 2-year period beginning on the "change date." [42] In a case where an owner shift involving a 5% shareholder triggers the ownership change, the change date is the date on which such shift occurs. Alternatively, if an equity structure shift triggers an ownership change, the change date is the date of the reorganization.

In general, the regulations under §368 provide that the acquiring corporation in a reorganization must either (i) continue at least one "significant" line of the acquired corporation's "historic business," or (ii) use, in any business, a "significant" portion of the acquired corporation's business assets. The regulations generally treat a historic business as the business most recently conducted by the acquired corporation. The regulations also specify that if the acquired corporation has more than one line of business, the acquiring corporation will satisfy the continuity of business enterprise requirement if it continues a significant line of business. Thus, under the regulations, the acquiring corporation may satisfy the continuity of business enterprise requirement if it continues one of three lines of business previously conducted by the acquired corporation.[43]

As explained previously, the pre-TRA 1986 requirements of §382(a) applicable to purchase transactions required that the loss corporation continue to carry on a trade or business "substantially the same" as that conducted before the change of ownership. Although the standard incorporated a significant degree of flexibility in that the loss corporation needed only to continue to conduct "substantially the same" trade or business, the regulations under §368 appear to incorporate an even less stringent standard. That is, the continuity of business enterprise test under the §368 regulations is satisfied if the acquiring corporation uses a "significant" portion of the target's historic business assets in *any* trade or business, regardless of whether it was historically conducted by the target. Therefore, factors traditionally analyzed under §382(a), such as whether the loss corporation continues to use the same locations, equipment and key employees, are irrelevant under post-TRA §382. [44]

Notwithstanding the adoption of a less stringent continuity of business test, there is a certain irony in the decision of Congress to incorporate the §368 regulations. Throughout the extended debate of the proposed revisions to §382, many commentators criticized the change of business test of pre-TRA §382(a) on the grounds that the standard was inherently imprecise.[45] Although Congress apparently agreed with this assessment,[46] it is not at all clear that TRA 1986 provides more definitive guidelines. For example, the continuity of business enterprise regulations rely, in several crucial respects, upon a facts and circumstances test. Thus, it remains to be seen whether taxpayers and the Service will reach a common understanding as to what constitutes a "significant line of business" or a "significant portion of [the] historic business assets in a business."

Comment: Given the broad legislative goals underlying post-TRA §382, a question can be raised as to whether any continuity of business test is appropriate. If an existing loss corporation changes its business operations, its NOL should be available, without limitation, to offset income generated by the modified business. Because one of the major purposes of the new legislation was purportedly to ensure that a "new loss corporation's" NOL is available to the same extent as it would be if no ownership change had occurred, it is unclear why a continuity of business rule should apply to a new loss corporation when presumably no such restriction applies to a loss corporation which experiences no ownership change.

2. *Annual Limitation on Carryforwards*

If an ownership change occurs and the continuity of business enterprise requirement described above is satisfied, the second major limitation on loss carryforwards established by TRA 1986 will apply. Under this set of rules, the amount of taxable income of the new loss corporation (*i.e.*, the original loss corporation in the case of a purchase or the surviving corporation in the case of a reorganization) that may be offset by "pre-change losses" shall not exceed, in any taxable year following the change date (*i.e.*, a "post-change year"), an amount referred to by the statute as the "§382 limitation." [47] The Act defines the term "§382 limitation" as the product of (i) the value of the old loss corporation immediately before the ownership change, and (ii) the applicable long-term tax-exempt rate.[48] As the name suggests, "pre-change losses" include NOL carryforwards arising in taxable years preceding the taxable year of the change date, as well as a pro-rata portion (based on the number of days before and after the change date) of any loss for the taxable year that includes the change date.[49] If two or more old loss corporations are reorganized into a single entity, a separate §382 limitation must be calculated for each corporation that undergoes an ownership change.

TRA 1986 provides that, for purposes of calculating the §382 limitation, the long-term tax-exempt rate shall be the highest of such rates in effect for the month in which the change date occurs or the two previous months. The long-term tax-exempt rate is a new rate which will be based upon the federal long-term rate established under §1274(d), as adjusted to reflect prevailing rates on long-term tax-exempt obligations with maturities of more than nine years.[50] The appropriate rate for calculating the annual absorption limitation had been the subject of considerable debate throughout the several-year period during which §382 was reviewed. In fact, the Senate bill adopted the federal mid-term (taxable) rate as the operative rate. The Conferees finally concluded that unless a rate lower than the federal long-term rate were adopted, there would exist an undue incentive for purchasing loss corporations.[51]

---

[42] §§382(c)(1), and (j).
[43] Regs. §1.368-1(d)(5), Example (1).
[44] Conference Report, *supra*, at II-189.
[45] *See* Final Report, *supra*, at 68-9.
[46] *See* H.R. Rep. No. 426, 99th Cong., 2d Sess. 260 (1985) (hereafter cited as "House Report").
[47] §382(a).
[48] §382(b)(1); Conference Report, *supra*, at II-185.
[49] §382(d)(1).
[50] §382(f); Conference Report, *supra*, at II-188.
[51] Conference Report, *supra*, at II-188.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Comment: Leaving aside the question of whether a mid-term or a long-term rate is more appropriate for calculating the annual absorption limitation, the decision of the Conferees to incorporate a long-term tax-exempt rate in §382 may be questioned on several more fundamental grounds. As noted previously, the neutrality principle on which the amendment rests dictates that a new loss corporation's NOL should be available to the same extent as if no ownership change had occurred and the corporation had invested its assets in profitable activities. Consequently, it appears that a yield based on debt instruments, such as those calculated under §1274, is inherently too low for §382 since the neutrality theory suggests that the hypothetical loss corporation should be presumed to have invested its assets in equity (rather than debt) investments. If this analysis is accepted, because of the greater risk associated with equity investment, §1274 rates are an altogether irrelevant yard stick for the calculations called for by §382. Further, in a similar vein, it can be questioned why the hypothetical loss corporation constructed by §382 should be treated as having invested its assets in tax-exempt securities, as opposed to taxable investments returning a higher yield. The latter form of investment would certainly appear to be more consistent with the legislative goal of calculating the return that a typical business would earn on an investment of its assets.

Section 382 defines the value of the old loss corporation as the value of the stock of such corporation (including preferred stock described in §1504(a)(4)) immediately before the ownership change.[52] The Conference Report directs the Treasury Department to issue regulations which, in appropriate cases, will treat as stock any warrants, options, convertible debt, or other similar interests in an old loss corporation. The legislative history notes that, normally, the purchase price at which stock in the old loss corporation sells is strong evidence of the value of such stock. This would not be the case, however, if the purchase price reflects a premium attributable to a control element.[53]

Comment: The legislative history of TRA 1986 offers little guidance as to how the value of a loss corporation with subsidiaries is to be calculated. If the parent's stock is acquired by purchase for cash, the purchase price would constitute persuasive evidence of the corporation's value under the principle noted above. When the ownership change results, however, from other types of owner shifts or from an equity structure shift, it is unclear how the value of an affiliated group of corporations is determined. For example, a group of corporations could be valued on a consolidated or a corporation-by-corporation basis. Presumably, these two approaches could produce different results in a particular case.

In calculating the NOL carryforward limitations, several special rules apply with respect to the taxable year of the old loss corporation which includes a change date. First, the annual limitation does not apply to the portion of the old loss corporation's taxable income that is allocable, on a daily pro rata basis, to the portion of the year falling before the change date.[54] Notwithstanding, the Treasury has the authority to issue regulations that will allow an old loss corporation to allocate to the pre-change period all income from specific sales of assets concluded before the change date. That is, an old loss corporation could elect to close its books as of the change date.[55] Further, for the taxable year in which the ownership change occurs (*i.e.*, the first year subject to the absorption limitation), the §382 limitation will be reduced by a pro rata portion determined by comparing the number of days in the taxable year occurring before and after the change date.[56]

Finally, if, in any taxable year ending after the change date, the new loss corporation has insufficient income to absorb the full §382 limitation, the unused portion is included in the §382 limitation for the next taxable year.[57] Thus, if losses available under the §382 limitation are not usable in a particular year because of the lack of income, such losses will be deductible immediately upon the realization of income by the new loss corporation in a later year.

3. *Special Rules Reducing Value of Old Loss Corporation*

In certain circumstances, the value of an old loss corporation used to calculate the §382 limitation is subject to adjustments. Specifically, the Act provides that the value shall be reduced by an amount equal to the aggregate capital contributions made to the old loss corporation as part of any plan, a principal purpose of which is to avoid the limitations of §382. The statute also dictates that, except as provided in regulations issued by the Treasury, all capital contributions made during the two years preceding an ownership change shall be conclusively presumed to fail the principal purpose test.[58] For these purposes, a capital contribution includes any amount received by the old loss corporation in exchange for its stock, as a contribution to capital, or in a transfer subject to §351. The Conference Report also identifies several types of capital contributions that should be exempted from the value reduction rule under the eventual regulations. These exempted capital contributions include many contributions made upon organizing a corporation, contributions made during the first year of a corporation's existence during which there is an NOL, and capital contributions made to enable a corporation to continue its basic operations (for example, to fund its payroll or other operating expenses).[59]

TRA 1986 also establishes a special rule applicable to old loss corporations with nonbusiness assets which comprise one-third or more of the fair market value of their total assets.[60] In these circumstances, the old loss corporation's value must be reduced by the *net* excess value of the nonbusiness assets. In calculating this net value, a reduction is allowed for a portion of the old loss corporation's debt that bears the same ratio to total debt as the value of its nonbusiness assets bears to the value of all assets. *See* Conference Report at II-190.

[52] §382(e)(1).
[53] Conference Report, *supra*, at II-187.
[54] §382(b)(3)(A).
[55] Conference Report, *supra*, at II-186.
[56] §382(b)(3)(B).
[57] §382(b)(2).
[58] §382(l)(1).
[59] Conference Report, *supra*, at II-189.
[60] §382(l)(4).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Although stock and securities generally fall within the definition of nonbusiness assets, a special rule applies to stock or securities in a subsidiary corporation in which the old loss corporation owns 50% or more of (i) the combined voting power of all classes of voting stock and (ii) the total value of all classes of stock. Stock or securities in a subsidiary that meets this test do not constitute nonbusiness assets, and, for purposes of the nonbusiness asset rule, the parent loss corporation is treated as owning its pro rata share of the subsidiary's assets.[61]

E. Built-In Losses and Gains

Drawing upon the present consolidated return regulations, post-TRA §382 incorporates special rules applicable to built-in losses and gains. Basically, §382 treats all net unrealized built-in losses that are recognized during the "recognition period" as pre-change losses subject to the §382 absorption limitation described above.[62] The "recognition period" begins on the change date and extends for five calendar years.[63] Post-TRA §382 defines the term "net unrealized built-in loss" as the amount by which the aggregate adjusted bases of the old loss corporation's assets exceeds the value of such assets immediately before the ownership change.[64] The statute further defines a "recognized" built-in loss as *any* loss recognized during the five-year recognition period upon the disposition of an asset except to the extent that the new loss corporation demonstrates that (i) such asset was not held by the old loss corporation immediately before the change date, or (ii) such loss exceeds the excess of the adjusted basis of such asset on the change date over the fair market value of the asset on such date.[65]

Post-TRA §382 also authorizes the Treasury to issue regulations which treat as built-in losses certain "amounts which accrue on or before the change date but which are allowable as a deduction after such date." [66] The legislative history indicates that deductions deferred by §§267 or 465 are examples of the type of deductions that may be treated by the regulations as built-in losses. Depreciation deductions, however, may not be treated as built-in losses.[67] Thus, if a new loss corporation holds an asset which, as of the change date, has a basis exceeding its fair market value, the corporation may deduct, without limitation, depreciation calculated with reference to the basis of the asset.

Comment: Although Congress borrowed from the consolidated return regulations when it incorporated in §382 the concept of a "built-in deduction," the term has a broader application under the consolidated return regulations. Depreciation clearly can constitute a built-in deduction under the consolidated return regulations and, as such, is subject to SRLY. Moreover, the Service has ruled that operating expenses (*e.g.*, salary, pension contributions, and interest) incurred by a cash basis taxpayer are built-in deductions to the extent they are allocable to, and "economically accrue" in, a separate return year. Rev. Rul. 79-279, 1979-2 C.B. 316. It appears that the eventual regulations could, in appropriate circumstances, treat operating expenses as built-in losses for purposes of §382. For example, in a situation similar to Rev. Rul. 79-279 where a cash basis loss corporation is subject to §382, operating expenses which are allocable to the period preceding the change date, but which are paid after such date, could fall within the built-in deduction rule of §382(h)(6).

Section 382 creates a parallel set of rules applicable to unrealized built-in gains. Thus, a new loss corporation which recognizes a built-in gain during a taxable year falling within the five-year recognition period is entitled to increase its §382 limitation for that taxable year by the amount of the recognized built-in gain.[68] The statute defines a "recognized built-in gain" as any gain recognized on the disposition of an asset during the recognition period if the new loss corporation demonstrates that (i) such asset was held by the old loss corporation immediately before the change date, and (ii) such gain does not exceed the excess of the fair market value of such asset on the change date over the adjusted basis of the asset on such date.[69]

Both the built-in loss and the built-in gain rules contain a *de minimis* exception. Thus, the built-in gain or the built-in loss rules will not apply if the respective built-in gain or loss does not exceed 25% of the value of the old loss corporation's assets immediately before the ownership change.[70] For purposes of the *de minimis* exception, the following items are excluded in calculating the fair market value of the old loss corporation's assets: cash, cash items (as determined under §368(a)(2)(F)(iv)), and marketable securities having a value that does not substantially differ from their adjusted basis.[71]

Whether the *de minimis* exception will prove to establish an adequate threshold level remains to be seen. Obviously, the burden on a new loss corporation imposed by the built-in gain and loss rules can be immense since the rules require the corporation to value (and perhaps even appraise) all of the assets held by the old loss corporation at the time of the ownership change. Moreover, the statute effectively creates a presumption that all losses recognized by the new loss corporation on asset dispositions are built-in losses. Consequently, a considerable premium will be placed on substantiating the value of an old loss corporation's assets as of the change date.

F. Bankruptcy Proceedings

Special rules under post-TRA §382 apply if (i) the old loss corporation, immediately before the ownership change, was subject to a bankruptcy court's jurisdiction in a Title 11 or similar proceeding, and (ii) the shareholders and creditors of the old loss corporation (determined immediately before such ownership change) own 50% of the value and voting power of the loss corporation's stock immediate-

[61] §382(l)(4)(E).
[62] §382(h)(1)(B).
[63] §382(h)(7)(A).
[64] §382(h)(3)(A)(i).
[65] §382(h)(2)(B).
[66] §382(h)(6).
[67] Conference Report, *supra*, at II-191. The Conferees directed the Treasury to prepare a study, no later than January 1, 1989, and report to the tax writing committees regarding the questions of whether built-in depreciation deductions should be subject to §382.

[68] §382(h)(1)(A).
[69] §382(h)(2)(A).
[70] §382(h)(3)(B).
[71] §382(h)(3)(B)(ii); Conference Report, *supra*, at II-190 to II-191.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ly after the ownership change.[72] In these circumstances, §382 does not apply to limit the NOL of the bankrupt loss corporation following an ownership change (as defined in §382(g)), provided that the stock for debt exchange, reorganization or other transaction causing the ownership change is ordered by the bankruptcy court or occurs pursuant to a court-approved plan.[73]

For purposes of the rule described above, stock received by a creditor in exchange for debt counts towards the 50% threshold only if (i) the creditor held the debt for at least 18 months before the filing of the bankruptcy, or (ii) the debt arose in the ordinary course of the loss corporation's trade or business and was held by the creditor who, at all times, had the beneficial interest in the claim represented by the debt.[74] Debt incurred for both ordinary expenses and capital expenditures may, of course, arise in the ordinary course of the loss corporation's business.

If the exception for bankruptcy proceedings applies, §382 provides for several adjustments to the loss corporation's NOL carryforward. First, the NOL (as well as the excess credits under §383) of the loss corporation must be reduced by one-half of the amount of the cancellation of indebtedness income which, but for the application of §108(e)(10)(B), would have been realized by the corporation upon any stock-for-debt exchanges occurring in connection with the bankruptcy reorganization.[75] The effect of this rule is to reduce the NOL carryforward by 50% of the difference between the amount of debt cancelled by creditors and the value of the shares they receive in the reorganized debtor. Further, the loss corporation's NOL carryforward is reduced by any amounts that were deducted as interest on debt that is ultimately converted into stock pursuant to the bankruptcy reorganization, provided that this reduction is limited to amounts deducted as interest during any taxable year ending during the three-year period preceding the taxable year of the ownership change.[76] Lastly, if a loss corporation qualifies for the bankruptcy exception and then, within two years of the reorganization, experiences an ownership change within the meaning of the statute, the §382 limitation for post-change years ending after the second ownership change shall be zero.[77] Thus, the effect of the second ownership change is to eliminate all NOL carryforwards arising before the second ownership change.

Act §621(f)(5) of TRA 1986 provides that the bankruptcy exception to §382 generally applies if a bankruptcy petition was filed after August 13, 1986.

Comment: Notwithstanding the arguments of several commentators, the bankruptcy exception in §382 does not apply to exchanges of stock-for-debt made pursuant to informal workouts. The Conferees, however, directed the Treasury to report to the tax committees before January 1, 1988 regarding the issue of whether informal bankruptcy workouts should be covered by §382.[78] Although the bankruptcy exception enacted in TRA 1986 does not apply to informal workouts, the final measure included in §382 is significant when compared to the original House bill, which would have severely limited NOL carryforwards following a bankruptcy reorganization. Specifically, the House bill would have required that the §382 limitation be computed with reference to the value of the loss corporation's equity immediately following the bankruptcy proceeding. *See* H.R. Rep. No. 426, 99th Cong., 1st Sess. 261-62 (1985). Thus, the final version of §382 incorporates the policy of pre-TRA §382(b)(7) by providing special relief for a loss corporation undergoing a bankruptcy reorganization.

G. Thrift Institutions

The bankruptcy rules described immediately above in part III, F apply, in a modified form, to reorganizations of thrift institutions administered by the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation, or a supervisory state financial agency. To qualify for the exception from §382, the reorganization generally must qualify as a G reorganization by reason of Code §368(a)(3)(D)(ii).[79] In such a case, the exception from §382 is available provided that shareholders, creditors and depositors retain a 20% (as opposed to 50% stock interest in the reorganized thrift institution.[80] For this purpose, post-TRA §382(l)(5)(F)(ii) treats deposits as stock. Further, a thrift institution which qualifies for the exception from §382 need not reduce its NOL carryforward by amounts relating to interest deductions and forgiveness of debt income associated with debt converted into stock in connection with the bankruptcy reorganization.[81] The bankruptcy exception in §382 applicable to thrift institutions is also more favorable in that ownership changes resulting from an issuance of stock or a subsequent equity structure shift do not trigger the §382 limitations provided that the stock issuance or equity structure shift is an integral part of the reorganization.[82] Thus, in these circumstances, thrift institutions are not subject to the "second ownership change" rule generally applicable to reorganized bankrupt corporations.

The favorable rules applicable to bankruptcy reorganizations involving thrift institutions apply only to equity structure shifts or other transactions occurring before January 1, 1989.[83]

H. Other Carryforwards

TRA 1986 also amended §383 to authorize the Treasury Department to issue regulations that will limit the ability of corporations to carry forward business credits, research credits, excess foreign tax credits and capital losses if ownership changes occur. The theory underlying these regulations will be that capital loss carryforwards and the "deduction equivalent" of credit carryforwards available to a new loss corporation will be limited to an amount of income that does not exceed the §382 limitation for the taxable year in question.[84]

[72] §382(l)(5)(A).
[73] Conference Report, *supra*, at II-192.
[74] §382(l)(5)(E); Conference Report, *supra*, at II-192.
[75] §382(l)(5)(C).
[76] §382(l)(5)(B).
[77] §382(l)(5)(D).
[78] Conference Report, *supra*, at II-192.
[79] §382(l)(5)(F)(iii).
[80] §382(l)(5)(F)(i).
[81] §382(l)(5)(F)(i)(II).
[82] §382(l)(5)(F)(iii)(II).
[83] §382(l)(5)(F)(iii).
[84] §383; Conference Report, *supra*, at II-194.

I. Anti-abuse Rules

TRA 1986 provides the Treasury with a broad, general grant of authority to issue all regulations necessary to prevent the use of pass-through entities, such as partnerships, to avoid the limitations of post-TRA §382.[85] During the legislative consideration of the amendments to §382, practitioners had speculated that rather than acquire a loss corporation directly, corporations might find it advantageous to form a partnership and make a special income allocation to the loss corporation, thereby enabling it to use its NOL. Based on a directive in the Conference Report, it appears that this and other similar techniques will be scrutinized in eventual regulations that attempt to limit disproportionate income allocations to "loss corporation partners."[86] Although a number of commentators suggested that the "bright line" tests of §382 should supplant §269 and its subjective "tax avoidance" standard,[87] Congress refused to repeal §269. Thus, §269 will remain available to the Service as a means of challenging acquisitions of loss corporations. The Conferees did indicate, however, that the *Libson Shops* doctrine is inapplicable to transactions covered by post-TRA §382.[88]

The Conference Report also states that the SRLY and CRCO rules of the consolidated return regulations will continue to apply to affiliated groups of corporations.[89] Under pre-TRA 1986 law, the interplay of §382 and the consolidated return regulations raised several issues. For example, the regulations applied the 50 percentage point change in ownership test of §382(a) at the parent level and provided further that, following the requisite ownership change, any subsidiary that did not meet the continuity of business test could not carry forward its NOL to the consolidated return for subsequent years.[90] A number of similar interpretative problems will face the Treasury as it attempts to reconcile the post-TRA §382 limitations with the SRLY and CRCO rules.

Comment: Following the acquisition of a loss corporation, it is virtually certain that, in any subsequent year, the amount of the loss corporation's NOL that is usable under the "§382 limitation" will differ from the amount available under the SRLY rules. This result will follow because the §382 limitation must be calculated as of the change date by multiplying the value of the loss corporation against the long-term tax-exempt rate. The amount of the loss usable under the SRLY rules will vary from year to year, based on the amount of taxable income the loss corporation contributes to the consolidated group in any particular year. Thus, it appears that in the case of a new loss corporation that is a member of a consolidated group, the amount of the new loss corporation's NOL deductible under §382 may be subject to deferral in any year in which the §382 limitation exceeds the taxable income of either the consolidated group or the loss corporation member.

[85] §382(m)(3).
[86] *See* Conference Report, *supra*, at II-194 to II-195.
[87] *See* Final Report, *supra*, at 34.
[88] Conference Report, *supra*, at II-194.
[89] *Id.*
[90] Regs. §1.1502-21(e)(1)(i).

J. 1976 Amendments

TRA 1986 repealed the amendments made to §§382 and 383 by the Tax Reform Act of 1976, effective retroactively as of January 1, 1986.[91] Consequently, even though the 1976 amendments temporarily became law on January 1, 1986, transactions that are not subject to post-TRA §382 generally will be controlled by the 1954 Code version of §382.

K. Effective Dates

As enacted in TRA 1986, post-TRA §382 generally applies to ownership changes (as defined in §382(g)) that occur on or after January 1, 1987. The new rules also apply to equity structure shifts that result from reorganizations pursuant to plans adopted on or after the same date.[92] If an ownership change occurs with respect to a parent corporation's stock that also indirectly affects a subsidiary, the effective dates apply to the transactions occurring at the parent level. Thus, to determine whether an equity structure shift affecting a subsidiary is subject to the post-TRA 1986 rules, the adoption date of the plan of reorganization at the parent level must be reviewed.[93]

The Conference Report indicates that a fairly liberal set of rules will apply to determine when a reorganization plan is adopted. Specifically, a plan will be treated as having been adopted on the earlier of (i) the date on which the directors of all parties to the reorganization adopt the plan or recommend such adoption to their shareholders, or (ii) the date on which the shareholders approve the plan. Further, for purposes of the effective date rules, a corporation's directors may approve a reorganization plan based on general principles and negotiations conducted to date and delegate to the officers the authority to execute a final, refined plan. A subsequent ratification of the final plan by the board will not jeopardize the earlier adoption date.[94]

Finally, for purposes of determining whether an ownership change has occurred, the earliest testing period under post-TRA §382 begins on May 6, 1986. Notwithstanding, if an ownership change (as defined in post-TRA §382(g)) occurs after May 5, 1986 but before January 1, 1987 and post-TRA §382 does not apply to such ownership change, then the earliest testing period under the amended statute will not begin until the day after such ownership change.[95] Consequently, if 60% of the stock of a loss corporation is purchased on June 1, 1986, a subsequent purchase of the remaining 40% of the shares in 1987 will not trigger the application of post-TRA §382 because the 1986 transaction constituted an "ownership change," which occurred after May 5, 1986 but before January 1, 1987. Accordingly the testing period begins on the day following the first transaction (*i.e.* on June 2, 1986 in the example), and the second transaction, standing alone, will not result in an ownership change within the meaning of the statute. Alternatively, if, in the above example, the first purchase on June 1, 1986 involved only 40% of the loss corporation's shares, the testing period under post-TRA §382 would begin on May 6, 1986 because the 40% change did not give rise to an

[91] TRA 1986, Act §621(f)(2)(A).
[92] TRA 1986, Act §621(f)(1); Conference Report, *supra*, at II-195.
[93] *Id* at II-195 to II-196.
[94] *Id* at II-196.
[95] TRA 1986, Act §621(f)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ownership change as defined in post-TRA §382(g). Thus, in the latter case, a second stock purchase after December 31, 1986 of 15% of the loss corporation's shares would trigger the application of post-TRA §382 since the two transactions, in the aggregate, would result in an ownership change within the applicable testing period beginning on May 6, 1986.[96]

[96] Conference Report, *supra*, at II-196.

Comment: As illustrated by the two examples above, the effective date provision for testing periods can produce results that are arguably inequitable. That is, a significant stock purchase after May 5, 1986 that falls short of the 50% threshold for an ownership change, will be aggregated with other changes in 1987. Alternatively, a purchase on the same date of perhaps only a few more shares, which exceeds the 50% standard, is effectively grandfathered under pre-TRA law.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 36

NEW RULES GOVERNING CORPORATE LIQUIDATIONS REPEAL OF GENERAL UTILITIES DOCTRINE

John P. Warner, Esq.
Silverstein and Mullens
Washington, D.C.

I. Overview

In order to implement fully a double tax regime on C corporations and their shareholders, Congress in the 1986 TRA overturned the long-standing doctrine, which had its source in *General Utilities and Operating Co. v. Helvering*,[1] and pre-1986 TRA §336, that a liquidating corporation recognizes no gain or loss on its distribution of assets in liquidation. In general, Act §631 provides that, except in §332 liquidations, gain and — with some exceptions — losses on assets distributed by a liquidating corporation are to be recognized as if those assets were sold to the distributee shareholders at their fair market value. Corporations liquidating under §332 would not recognize gain or loss on distributions to the extent made to their 80% shareholders. Under §338(a), a target corporation whose stock is acquired in a qualified stock purchase could in general obtain a fair market value basis in its assets only at the cost of a tax on all gain inherent in those assets. In order to prevent the circumvention of a double tax on the liquidation of C corporations, C corporations that elect S corporation status after 1986 are subject to a separate tax upon gain from any taxable disposition within 10 years after the election with respect to pre-election appreciation. Act §631, amending Code §1374.

In general, the effective date for these provisions is January 1, 1987. However, transition relief is given to transactions carried out before January 1, 1988 pursuant to pre-August 1, 1986 contracts or corporate actions. Act §633(c)(1)(A). In addition, no gain or loss — other than with respect to ordinary income assets, short-term capital assets and installment obligations — is recognized by certain closely held corporations with a value of less than $10,000,000 with respect to liquidating sales and distributions (and deemed §338 sales) before January 1, 1989. Act §633(d).

II. Discussion

A. *Section 331 Liquidations*

1. *In General*

Under pre-1986 TRA §336, a liquidating corporation did not recognize gain or loss on a complete liquidating distribution except with respect to any LIFO depreciation recapture amount and the disposition of installment obligations pursuant to §453(B). Act §631 revises §336 to provide that a liquidating corporation will in general recognize gain or loss on its distribution of property in complete liquidation as if the corporation sold each of its assets at its fair market value[2] (or, to the extent greater, for the amount of debt to which each distributed property is subject or which the distributee shareholder assumes)[3] to the distributees. Aside from the transition relief given to certain small closely held corporations, discussed *infra*, no relief (other than the use of a S corporation[4]) is available from the double taxation rule for most corporations.[5]

To prevent circumvention of the general rule of gain of loss recognition to liquidating corporations, the 1986 TRA, Act §631(c), also amends §311 to provide that corporations distributing appreciated property (other than obligations of the distributing corporation or distributions qualifying for §355 treatment at the shareholder level) in nonliquidating distributions will recognize gain as if they sold such property at fair market value to the distributee.[6]

2. *Limits on Loss Recognition*

To prevent the acquisition of loss assets, the distribution of which would offset both corporate and shareholder gain, the liquidating corporation will not recognize any loss on a liquidating distribution of property to shareholders who own (directly or by attribution within the meaning of §267(c)) 50% of the stock of the liquidating corporation unless the property is distributed to all shareholders on a pro rata basis and the property is not "disqualified property" (*i.e.*, it was not acquired by the liquidating corporation

[1] 296 U.S. 200 (1935).

[2] Act §631(a), enacting revised Code §336(a).

[3] Act §631(a), enacting revised Code §336(b).

[4] Although corporations that have never been C corporations or that elected S corporation status pursuant to elections made before January 1, 1987 generally are not subject to a double tax regime on liquidation by operation of the normal rules of subchapter S, Act §632 revised Code §1374 to provide a tax equal to the highest rate of corporate tax on the taxable sale, exchange or disposition made within 10 years after electing subchapter S status of any asset held by the corporation on the election date to the extent of the appreciation in value of such asset ("built-in gain") as of the election date. For a more detailed discussion of the "built-in gain" tax imposed on S corporations, *see* Chapter 38, *infra*.

[5] Certain corporations with pass-through features, such as real estate investment trusts (REITs), may avoid such double taxation, *see* §§562(b) and 857(b)(2). For a complete discussion of REITs, *see* Chapter 41, *infra*.

[6] For a discussion of these rules, *see* Chapter 37, *infra*.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

in a §351 exchange or as a contribution to capital during the five years preceding the distribution). Denial of loss recognition in such a case would result even if the property was not distributed to the contributing shareholders and even if the property's fair market value exceeded its adjusted basis at the time of contribution.[7]

Example: A, B, and C, who are brothers, each owns one-third of the stock of Corporation X. On April 15, 1980, Corporation X purchased on the open market for $100 stock in a publicly traded company. On July 31, 1992, when the publicly traded stock is worth $80, Corporation X is liquidated, with B receiving all of the publicly traded stock. Because the publicly traded stock was distributed entirely to B — who under the attribution rules of §267(b) and (c)(4) is related to Corporation X — and not one-third to each of the shareholders, Corporation X does not recognize the $20 loss realized on the distribution. Presumably, B takes an $80 basis in such stock under §334(a) and begins his holding period on the date of the liquidating distribution.

There appears to be no statutory restriction on the recognition of gain on the liquidating distribution of appreciated property contributed in contemplation of the liquidation solely to permit the use of losses that are to be recognized on the liquidation, although in certain cases — especially where the appreciated assets consist of securities or assets not used in the corporation's trade or business — the Service could attack such transactions as shams.[8] However, unless there would otherwise be a capital loss on the shareholders' stock or the shareholders had otherwise unusable capital losses, the shareholders would be subject to an additional capital gain on their stock as a result of the contribution.

Example: Corporation X owns property with a fair market value of $100 in which it has an adjusted basis of $90 but earns no net income from operations. Corporation X also has a net operating loss carryover of $50. The corporation's shareholders contribute property used in its business having a value of $60 and an adjusted basis of $20. If the corporation is liquidated, the $40 of gain realized on the contributed property plus the $10 gain on the property previously owned will be recognized by the corporation but will be offset by the net operating loss carryover. Thus, barring application of a step transaction or sham doctrine, Corporation X will pay no tax on the liquidation and the shareholders will take a $60 basis in the contributed property. The shareholders would, however, recognize $40 more in capital gains (or $40 less in capital losses) on their shares as a result of the contribution and liquidation.

Further, for purposes of computing a liquidating corporation's loss on the sale, exchange or distribution of property acquired by the corporation in a §351 exchange or contribution to capital (or from the sale or exchange of property having an adjusted basis determined by reference to such property) where one of the principal purposes of such acquisition was to generate a loss in connection with the liquidation, the adjusted basis of such property will be reduced by the excess of the property's adjusted basis at the time of its acquisition over its fair market value on such date.[9] For this purpose, it is presumed, except to the extent provided in regulations, that loss assets acquired within two years before the adoption of the plan of liquidation were acquired with the tainted purpose.[10] Loss assets acquired more than two years before adoption of a plan of liquidation, unless they have no "clear and substantial relationship" to any of the corporation's existing or planned businesses, will not be treated as having been acquired with a tax avoidance purpose.[11] The rule does not apparently reduce the basis of such property for purposes of determining depreciation or amortization deductions.

The Conference Report at II-200 states that the conferees intended that in appropriate cases, if the adoption of a plan of complete liquidation occurs in a taxable year following the date on which the tax return including the loss disallowed by revised §336 is filed, the liquidating corporation may recapture such loss on the tax return for the taxable year in which such plan of liquidation is adopted. Alternatively, the corporation could file an amended return for the taxable year in which the loss was reported.

3. Regulatory Authority

Initial planning to avoid these new rules will have to be done cautiously. New §337(d) gives the Service broad authority to issue regulations "to carry out the purposes of" the repeal of the *General Utilities* doctrine, including regulations to ensure the purposes of the repeal are not circumvented by the (1) consolidated return regulations and reorganization rules, and (2) regulations to coordinate the provisions of the 1986 TRA §§631-634 with existing rules concerning the tax treatment of foreign corporations and their shareholders.[12]

B. Section 337 Liquidations

The 1986 TRA repeals former §337 and replaces it with a revised §337, discussed *infra*.[13] Pre-1986 TRA §337 generally provided that if a corporation adopted a plan of liquidation and, within 12 months thereafter, distributed all of its assets to its shareholders, no gain or loss would be recognized on the sale of certain property within that 12-month period. Thus under post-1986 TRA law, gain or loss on such sales — subject to the limits on loss recognition as to property contributed to the corporation for loss recognition purposes — is fully taxable to the liquidating corporation.

Comment: It may be of small consolation to taxpayers,

[7] Act §631(a), enacting §336(d)(1). Even though the corporation will not recognize the loss, the shareholder will, as under pre-1986 TRA law, take a §334(a) fair market value basis in the distributed loss asset because he recognizes gain or loss with respect to his stock under §331.

[8] *See Law v. McLaughlin*, 2 F. Supp. 601 (N.D. Cal. 1933).

[9] Act §631(a), enacting new Code §336(d)(2)(A). Rather than denying a loss deduction in the year such an asset is disposed of (at which time the prospects of a liquidation could be unknown), Treasury is authorized to permit a liquidating corporation to increase the amount of gain it recognizes in the year of liquidation by the amount of the disallowed loss. New §336(d)(2)(C).

[10] Act §631(a), enacting new §336(d)(2)(B).

[11] H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-201 (1986) ("Conf. Rep.").

[12] Act §631(a), enacting revised §337(d)(1) and (2).

[13] Act §631(d)(2), effective generally with respect to liquidations completed after 1986.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

but when the repeal of §337 is fully effective, practitioners will have little cause to worry about the *Court Holding* doctrine.

C. Section 333 Liquidations

Effective for liquidations completed after 1986, Act §631(e)(3) repeals §333, which provided for nonrecognition of gain to individual shareholders and certain non-controlling corporate shareholders on the liquidation within a single calendar month of a corporation, except to the extent that the liquidating corporation had earnings and profits or distributed money, stock or securities. Because corporations whose stock appreciates in value either have earnings and profits or have appreciated assets (the distribution of which, under revised §336, would generate earnings and profits), no benefit would result from a §333 election.

D. Section 332 Liquidations

1. In General

The 1986 TRA revised §337, to provide that a corporation liquidating under §332 will not recognize gain or loss on distribution of its property to an "80% distributee," *i.e.*, an 80% shareholder.[14] New §336(d)(3) provides that the liquidating corporation will not recognize loss on the distribution of property to minority shareholders in a §332 liquidation.[15] Gain will be recognized where the 80% corporate distributee is a tax-exempt entity unless the property distributed to it in liquidation is used by the entity in a taxable unrelated trade or business.[16] Gain is also recognized (except as provided in regulations) where the 80% corporate distributee is a foreign corporation.[17] Finally, gain will be recognized on the distribution of appreciated property to any minority shareholders in a §332 liquidation.[18]

In many cases, the rules will place a premium on distributing to minority shareholders cash and other property on which no gain or loss would be realized. Minority shareholders would take a fair market value basis under §334(a) in loss property distributed to them, so that the loss would evaporate without any tax benefit to either the corporation or the shareholders. On the other hand, the corporation would recognize gain on the distribution of appreciated property to such shareholders.

> *Example*: The stock of Corporation Z is owned 80% by Corporation N and 20% by A, an individual. Corporation Z has operating assets with a $60 fair market value and a $40 basis, investment assets with a $20 fair market value and a $10 basis, and $20 cash. If Corporation Z is liquidated in 1989 and A receives the investment assets in the liquidation, Corporation Z would recognize the $10 gain realized on those assets. If, on the other hand, A received the cash and Corporation N received the operating and investment assets in the liquidation, Corporation Z would recognize no gain or loss.

2. Section 336(e) Election

TRA 1986 also enacts new §336(e), which provides that, pursuant to regulations, where a corporation owns at least 80% of the voting power and value of a second corporation, and sells, exchanges or distributes (including in a liquidation) all of the stock it owns in the second corporation, the selling corporation may, in effect, elect to be taxed as if it had sold the second corporation's assets in a taxable sale and exclude any gain or loss from the stock sale. In effect, such 80% shareholders could treat stock sales and distributions as if they had sold or distributed the second corporation's assets after it had been liquidated. Presumably, as is true of elections under §338(h)(10), the target corporation would take a basis in its assets determined by reference to the stock purchase price and the purchasing or distributee corporation would take a basis in the target corporation stock equal to the purchase price.[19]

> *Example*: Corporation N owns all of the stock of Corporation Z, with which it does not file a consolidated return. The stock is worth $200 but Corporation N has a $50 basis in it. Because Corporation Z has reinvested much of its earnings to meet capital needs, it has a $160 basis in its $200 worth of assets. If Corporation N sells all of its Corporation Z stock to B, an individual, for $200 in 1988, under normal rules it would recognize $150 in gain and would (at 34% rates) be subject to a $51 tax on the sale. However, if Corporation N makes an election pursuant to regulations to be issued under section 336(e), it would recognize only the $50 gain inherent in Corporation Z's assets and would be subject only to $17 of federal income tax on the sale.

Although this election resembles a §338(h)(10) election, it is — unlike §338(h)(10) — potentially available for sales to individuals and to related corporations and for distributions — including liquidating and non-liquidating distributions not qualifying for §355 treatment.[20] Unlike §338(h)(10), which is available for certain stock acquisitions taking place over a period of no more than one year, the language of §336(e) suggests that all of the controlling corporate shareholder's stock interest must be sold (or distributed) in the same transaction.

3. Mirror Subsidiary Transactions

Regs. §1.1502-34 permits the aggregation of stock ownership by all members of a single consolidated group in determining whether the liquidation of a corporation quali-

[14] Act §631(a), enacting revised Code §337(a).

[15] Act §631(a). The loss inherent in an asset distributed to the minority shareholders in a §332 liquidation will be eliminated permanently, because such shareholder will recognize gain or loss on his stock under §331, and thus, will take a fair market value basis in such asset under §334(a).

[16] Act §631(a), enacting §337(b)(2)(A). If such a distributee disposes of distributed property — even in an otherwise tax-free transaction — or no longer uses the property in an unrelated trade or business, the gain that would have been recognized on the distribution by the liquidating corporation had the tax-exempt entity not used the property in an unrelated trade or business will be recognized by the distributee as unrelated business taxable income. §337(b)(2)(B).

[17] Act §631(d), enacting revised Code §367(e)(2).

[18] Conf. Rep. at II-202.

[19] Regs. §1.338(h)(10)-1T(g), Example 3(ii)(B).

[20] The Conference Report at II-204 provides that, in the case of a sale or distribution of all of the stock of such a controlled subsidiary to a 50% related person under §368(c)(2), regulations permitting the use of the §336(e) election will apply liquidation-reincorporation principles, possibly including "special rules for such [target] corporation's Section 381(c) tax attributes so that net operating losses may not be used to offset liquidation gains, earnings and profits may not be manipulated, or accounting methods may not be changed."

fies under §332 as the liquidation of an 80% controlled subsidiary. However, a question has arisen as to whether, absent regulations, the same aggregation rules would apply to treat each of the consolidated distributees in such a case as an "80% distributee" for purposes of permitting the liquidating corporation to avoid recognition of gain on the distribution. A colloquy between Senators Dole (R-Kans.) and Packwood (R-Or.) during the Senate floor debate on H.R. 3838 indicates that the aggregation rules of Regs. §1.1502-34 should apply — at least barring a change in the regulations — both for purposes of §332 and new §337.[21] However, that interpretation was challenged by Ways and Means Chairman Rostenkowski in a subsequent statement.[22]

Permitting the aggregation of stock ownership is critical for, among other things, so-called mirror subsidiary transactions, where an acquiring corporate group which, to fund a leveraged buy-out or otherwise, wants to sell off certain subsidiaries or divisions of a target corporation. To avoid tax on such resales, the acquiring group would have to obtain a fair market value basis in the unwanted stock or assets.

To accomplish this result, the acquiring group would form subsidiary corporations that would mirror those target corporation's subsidiaries or divisions that the acquiring group wished to sell. The group would contribute to those mirror subsidiaries cash equal to the fair market value of those target divisions or subsidiaries. The mirror subsidiaries and the acquiring corporation would then form a corporate acquisition vehicle that would be part of the acquiring consolidated group. After the acquisition vehicle purchased the target corporation's stock, the target corporation and the acquisition vehicle would be liquidated, with stock of the appropriate subsidiaries or assets of the appropriate divisions being distributed to the respective mirror corporations. Because the mirror subsidiaries' parent corporation would have a fair market value basis in the mirror subsidiaries' stock, it could sell such stock without any gain being realized. However, unless liquidation of the acquisition vehicle qualified for §332 treatment and the mirror subsidiaries qualified as 80% distributees, distribution of the target subsidiaries' stock or the target division's assets in the liquidation of the acquiring vehicle would be taxable to the acquiring vehicle.

> *Example*: Corporation T has two divisions, H and W. Division H owns assets with a fair market value of $50 in which Corporation T has a $30 basis. Division W owns assets with a fair market value of $50 in which Corporation T has a $50 basis. If Corporation A purchased the stock of Corporation T directly for $100 but wished to dispose of Division h, it or Corporation T would recognize $20 in gain. However, if Corporation A contributed $50 to each of two newly formed consolidated subsidiaries, Corporation M and Corporation N, and has those corporations each purchase 50% of the stock of Corporation T, and if Corporation T were thereafter liquidated with Corporation M receiving the Division H assets and Corporation N receiving the Division W assets in a §332 liquidation as to which Corporations M and N were "80% distributees," Corporation A could dispose of the Division H assets at no tax cost by selling the Corporation M stock, in which it has a $50 basis. However, if Corporations M and N were not "80% distributees," Corporation T would recognize gain on its distribution to Corporation M of the Division H assets under §336(a).

In a December 9, 1986 letter to congressional tax leaders, Treasury Secretary Baker indicated that, until the subchapter C study mandated by Act §634 is completed, Treasury would not issue regulations dealing with the issue of whether the aggregation rules of the consolidated return regulations would apply for purposes of §336(d)(3). The letter noted that, before the mandated subchapter C study is completed (or before legislation addressing the issue is enacted), "mirror subsidiary transactions will be subject to the Act as written," which, the letter noted "does not directly indicate whether the existing aggregation rules of the consolidated return regulations is applicable . . . ." The letter concluded that the IRS will "resolve ambiguities . . . as cases arise in the ordinary administrative process." The effect of the letter seems to discourage all but the most courageous from engaging in mirror subsidiary transactions and to put pressure on Congress to resolve the issue legislatively.

E. Section 338 Transactions

Act §631(b) amends §338(a)(1) to provide that a target corporation in a qualified stock purchase may obtain a fair market value basis in its assets under a §338 election only if it is treated as having sold all of its assets for their fair market values in a taxable transaction. This rule is consistent with the philosophy behind elimination of tax-free treatment for liquidating corporations on liquidating distributions or sales. In most cases, this rule would make a §338 election unattractive because all inherent gain in the target corporation's assets would be taxable at the time of the qualified stock purchase, whereas the benefits of the basis step-up obtained by making the election would be recognized only over time.

In contrast to the new rules regarding liquidating distributions, the new rules governing §338 elections contain no exceptions to the rule of loss recognition by the target corporation. Thus, there may be an incentive to contribute before completion of the qualified stock purchase non-amortizable and non-depreciable loss assets to a target corporation that has appreciated depreciable or amortizable assets or that has appreciated assets that the acquiring corporation wishes to dispose of. On the deemed §338 sale, the target corporation's gain would be offset — subject to the capital loss restriction rules — by the losses recognized with respect to the contributed assets. The target would get the same basis step-up in its gain assets that it would have obtained without the contribution.[23]

[21] 132 Cong. Rec. S13958 (daily ed. September 27, 1986).
[22] 132 Cong. Rec. E3389 (daily ed. October 2, 1986).

[23] It does not seem that §338(i)(1) gives the Service authority to issue regulations denying either loss recognition or the basis step-up because that provision merely authorizes regulations to treat stock and asset acquisitions the same. Subject to application of the sham transaction doctrine or a reverse *Court Holding* doctrine, a shareholder could contribute loss assets to a corporation about to sell its assets and the corporation would recognize the loss on the subsequent sale.

Moreover, the contributing shareholders would reduce the taxable gain recognized on the sale of their stock.

Needless to say, if the pre-sale contribution of loss property serves no business purpose of the target corporation — as might be the case where non-business assets are contributed immediately before the stock sale and are disposed of immediately after the sale — the contribution might be ignored for tax purposes.[24]

Example: Corporation T has $100 worth of depreciable assets used in its business and a $70 basis in those assets. In contemplation of a possible sale of its stock in Corporation T, A, the sole shareholder of the corporation, contributes $30 worth of securities in which he has a $60 basis. On January 1, 1989, A sells all of his Corporation T stock to Corporation P for $130. Corporation P properly elects §338 treatment with respect to the sale. Corporation T's $30 gain recognized on the deemed sale of its business assets is offset by the $30 loss it recognizes from the deemed sale of the securities. Corporation T, after the election, takes a $100 basis in the business assets and a $30 basis in the securities. Absent the contribution of the securities, Corporation T would have incurred a taxable gain of $30, or a federal income tax of $10.20 assuming a 34% rate, and A would have recognized a taxable gain of $30, or a tax of $8.40 assuming a 28% tax rate, on the sale (or, more likely, the sale price would have been reduced to reflect the corporate level tax).

Comment: The only incentive for a purchasing corporation to elect §338 treatment for a target corporation, the deemed sale of whose assets would generate a net loss, would be as consideration for a purchase price reduction. The benefits of the loss could be used only by the selling company[25] and not by the purchasing company, but the purchasing company would suffer the disadvantages of the lower asset basis.

As a result of the general recognition of gain to the target corporation in a section 338 qualified stock purchase, unless the §338 consistency rules are changed, the new rule of target corporation recognition puts an additional premium on making at least the carryover basis election in Temp. Regs. §1.338-4T(f)(6). Act §631(b)(3), however, expands §338(h)(10) to permit corporations which sell the stock of an affiliated target corporation in a qualified stock purchase as to which a §338 election is made to treat the sale as a sale of the target corporation's assets and not as a sale of the target corporation's stock, even if the selling corporation and the target corporation were not members of a consolidated return group. If a target corporation's assets cannot for some reason be purchased directly, use of §338(h)(10) or new §336(e), discussed above, where available may be attractive because either would permit the purchasing corporation to take a fair market value basis in the target corporation's assets at the cost of a single tax on the transaction.

[24] Although the limitations on loss recognition contained in revised §336(d) do not apply to deemed §338 sales, the Service's broad regulatory authority in revised §337(d) does apply to §338.

[25] *See generally* Regs. §1.338-IT(f).

F. Effective Dates and Transition Rules

1. In General

Although the 1986 TRA provides that the effective date of the repeal of the *General Utilities* doctrine is August 1, 1986, as a practical matter the new rules are not effective for liquidations completed before January 1, 1987, or for §338 transactions the acquisition date for which is before January 1, 1987.[26] In addition, there are several general transition rules that postpone the effective date. Distributions, sales and exchanges pursuant to pre-August 1, 1986 (i) plans of liquidation, (ii) binding contracts to sell more[27] of the stock of a liquidating company, or (iii) binding contracts to sell substantially all of a corporation's assets are not subject to the new rules if the appropriate liquidations are completed before January 1, 1988.[28] Section 338 transactions with pre-January 1, 1988 acquisition dates would not be subject to the new rules if carried out pursuant to pre-August 1, 1986 binding contracts.[29]

2. Pre-1989 Liquidations of Qualified Corporations

Somewhat longer transition relief would be available to some extent for certain closely held small corporations. The new rules apply only to a limited extent to liquidating sales, exchanges and distributions (and deemed sales pursuant to §338 elections) of "qualified corporations" — corporations more than 50% of the value of whose stock as of August 1, 1986 and all times thereafter is held by no more than 10 individuals, estates and certain trusts; which have a fair market value less than $10,000,000; and which completely liquidate before January 1, 1989.[30]

For purposes of determining whether no more than 10 qualified persons own more than 50% of the value of a corporation's stock, stock owned by all people related under §318(a)(1) is treated as owned by a single individual.[31] Thus, if two family groups — each consisting of a husband and wife, three children and five grandchildren who each own 5% of the stock — control a corporation meeting the fair market value tests, the corporation is a qualified corporation. On the other hand, if a corporation worth less than $10 million at the relevant times is owned 45% by an ESOP, 10% by each of three brothers and 2.5% by each of 10 unrelated employees, it is not a qualified corporation because the ESOP is not a qualified shareholder and the brothers' stock is not attributed to one another under §318.

In contrast to the rules governing qualification for a subchapter S election, the existence of non-qualified shareholders does not disqualify a corporation from "qualified

[26] Act §633(a). Note that in the case of a qualified stock purchase the acquisition date for which occurs on or before December 31, 1986, a §338 election pursuant to which the target corporation would not generally be subject to tax on the deemed sale of assets may be made after 1986 so long as it is made within eight and one-half months after the pre-1987 acquisition date. *See* Act §633(a)(2) and Code §338(g)(1).

[27] Concurrent resolutions passed by both the House and the Senate would have changed this to apply only to pre-August 1, 1986 contracts to sell more than 50% of the stock of a liquidating corporation. However, because of differences between the House and Senate versions of the resolution on other issues, no such resolution was enacted before the 99th Congress adjourned.

[28] Act §633(c)(1)(A)-(C).

[29] Act §633(c)(1)(D).

[30] Act §633(d)(1), (5) and (6).

[31] Act §633(d)(6)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

corporation" status; in fact, it seems that stock owned by a corporation (which cannot itself be a qualified shareholder) more than 50% of the stock of which is owned by an individual shareholder of the corporation seeking qualified corporation status would be attributed to the individual shareholder for purposes of meeting the more-than 50% ownership test. However, it is not clear that stock owned by a corporation would for this purpose be attributed to a controlling shareholder of that corporation if such controlling shareholder did not actually own stock in the corporation for which qualified corporation status is sought.

The concurrent resolutions passed by both the House and Senate would have restricted qualified persons to those who owned stock for at least five years prior to adoption of the plan of liquidation or qualified stock purchase or, if lesser, throughout the corporation's existence. However, due to differences on other issues, no concurrent resolution was enacted before the 99th Congress adjourned. Whether a technical corrections bill would impose this requirement retroactively remains to be seen.

Under the qualified corporation transition rule, qualifying corporations will nonetheless recognize gain or loss after 1986 with respect to ordinary income and short-term gain property and with respect to the disposition of installment obligations [32] (and would continue to be subject to the pre-1986 rules regarding depreciation recapture and tax benefits). Closely held corporations valued at no more than $5,000,000 will fully avoid gain or loss recognition upon liquidating distributions, sales or deemed §338 sales on long-term capital assets other than installment obligations. Corporations valued between $5,000,000 and $10,000,000 will avoid gain or loss recognition on such long- term capital assets in a declining proportion as the value of such corporations approached $10,000,000. Act §633(d)(3).

Whether to liquidate before 1989 to take advantage of the transition rule for qualified corporations will depend on numerous factors, including the amount of appreciated ordinary and short term capital assets the corporation owns, the burden of corporate level tax on annual earnings, the amount of additional depreciation and similar deductions that would be available following the liquidation, the desirability of getting assets out of corporate solution while current shareholders are alive, the feasibility of electing subchapter S treatment, and the availability of a suitable non-corporate vehicle to operate the corporation's business or property. Where transition relief is deemed desirable, most qualified corporations — other than those with rapidly appreciating values that could increase by 1988 to more than $5 million —would probably choose to delay a liquidation until 1988 to take advantage of the fully phased-in scheduled tax rates.

Example: The stock of Corporation T is owned 50% by each of two individuals, A and his son B, each of whom in 1988 has a $300,000 basis in his shares. Corporation T has a fair market value of $4 million, and owns the following assets: a rental apartment building which has a $3 million value (of which $500,000 is attributable to the underlying land) which it built in 1980 for $2.1 million (plus a $300,000 land cost) and which it has depreciated on a straight-line basis over a 30-year estimated useful life; and (ii) $1 million in marketable securities which it has held more than six months, in which it has an $800,000 basis. The building generates $300,000 in annual net operating income after debt service on an interest-only mortgage and the securities generate $60,000 in annual interest and dividend income. Thus, in 1988, assuming no liquidation, the corporation will generate $360,000 in net cash flow and $290,000 in taxable income after depreciation. Assuming a 34% corporate tax rate and a 28% individual tax rate, the shareholders would retain after taxes approximately $207,808 [.72($290,000 x .66) + $70,000].

If Corporation T were to liquidate in 1988, it would recognize $112,000 (.2 x $560,000) in §291 depreciation recapture but would otherwise avoid corporate level tax on the liquidation. Thus, the shareholders would together receive $3,961,920 ($4 million - $38,080 corporate level tax) in the liquidation. Each shareholder would be taxed on $1,680,960 ($1,980,960 - $300,000) of gain, resulting in a $470,669 individual tax liability. The shareholders would each net $1,510,291. Total tax on the liquidation would be $979,418.

Following the liquidation, A and B could sell $979,418 of the securities to pay taxes on the liquidation. Annual income from the corporation's assets, assuming a 6% return, would thus be reduced by approximately $58,750. However, the shareholders would take a $2.5 million basis in the apartment building for depreciation, which they could write off over 31.5 years, resulting in $79,365 in annual depreciation deductions. The shareholders would thus earn $301,235 in cash annually or $221,870 in taxable income after depreciation. After payment of individual income taxes at 28%, A and B together would net $239,111 annually or approximately $37,000 per year more than prior to the liquidation.

If Corporation T were not liquidated until A died in 1990, at which time Corporation T's basis in the apartment building (and underlying land) was $1.7 million and B's basis in his shares was $230,000 (because of post-1988 distributions of cash in excess of earnings and profits), Corporation T would would be subject to tax on $1.5 million [$4 million - ($1.7 million + $800,000)] in gain, which at 34% would be $510,000. A's estate or heirs would be subject to no tax on their shares by operation of §1014. B would be subject to a 28% tax on $1,515,000 [$2 million - ($255,000 + $230,000), or $424,200. Thus, a total of $934,200 in federal income tax — or approximately $45,000 less than in a 1988 liquidation — would be imposed on the liquidation.

Following the liquidation, A and B could sell $934,200 of the securities to pay taxes on the liquidation. Annual income from the corporation's assets would, assuming the securities would have earned 6% per year, thus be reduced by approximately $56,000. The shareholders would take a $2.5 million basis in the apartment building for depreciation, which they could write off over 31.5 years, resulting in $79,365 in annual depreciation deductions. The shareholders would thus have $304,000 in pre-tax earnings annually or $224,635 in taxable income after depreciation. After payment of individual income taxes at 28%, A and B

[32] Act §633(d)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

together would net $241,102 annually or only about $2,000 per year more than following a 1988 liquidation.

Some uncertainty exists as to the scope of the qualified corporation exception. Act §633(d)(1) provides that, in the case of a pre-1989 liquidation of a qualified corporation, the amendments made by Act §§631-634 [33] will not apply to "the applicable percentage of gain or loss which (but for [Act §633(d)(1)]) would be recognized by reason of the amendments made by this subtitle." Although this language clearly applies to corporate level gain realized on the pre-1989 liquidation of a qualified corporation, it does not seem to apply to some of the "technical and conforming" changes made by Act §631(d). For example, Act §631(d)(3) repeals Code §333, which is not a corporate nonrecognition provision but a shareholder nonrecognition provision. In Rev. Rul. 87-4, however, the IRS stated its position that "*all of the amendments made by subtitle D* [containing Act §§631-634] *are covered by the transition rule for qualified corporations*" and therefore relief is available for shareholder-level gain as well as corporate-level gain. (Emphasis added.) Thus, Rev. Rul. 87-4 concludes that the qualified corporation exception applies to §333 liquidations completed before January 1, 1989. Accordingly, the shareholders' pro rata shares of corporate earnings and profits in a §333 liquidation of a qualified corporation will be increased only to the extent that corporate-level gain recognition is required (such as for short-term gain) under the transitional rules.

Example: X is a qualified corporation with an applicable value of $7 million, accumulated earnings and profits of zero, and whose sole shareholder, A, has a basis in X's stock of $6 million. In 1988 X liquidates under §333, distributing its only asset, a parcel of undeveloped land with a fair market value of $4 million and a basis of $3 million, which X has owned for more than 6 months. X recognizes $400,000 of the gain (*i.e.*, 40%), resulting in an increase in X's earnings and profits of $264,000 ($400,000, minus X's tax on the gain, $136,000). A's gain on the distribution is $864,000 ($6,864,000 minus $6,000,000), of which he must recognize $264,000, representing the increase in earnings and profits.

Note that the qualified corporation transition relief is mandatory; a qualified corporation liquidating in 1987 or 1988 that has long-term capital loss properties it would like to distribute to its shareholders but would like to recognize the losses, for example, cannot as such elect out of Act §633(d). However, it might be able to "disqualify" itself by sales or transfers to non-qualified persons so as to violate the stock ownership requirements.[34] To be given effect, such transfers would have to have economic significance. However, that would generally be the case so long as the transferees retained the proceeds of liquidation.

[33] As enacted, Act §633(d)(1) literally exempts pre-1989 liquidations of qualified corporations from corporate level gain recognition imposed only by the amendments made by Act §633. However, §633 does not impose corporate level gain recognition but merely contains the transition rules themselves. However, to read the provision literally would be to render §633(d) meaningless. Moreover, the concurrent resolutions passed by both the House and the Senate but not enacted would have modified the subsection to exempt all corporate level gain from recognition otherwise resulting from the changes made by §§631-634. Presumably, a technical corrections bill will so provide.

[34] A sale of long-term capital loss property by a liquidating corporation to its shareholders might not be given effect since the proceeds of the sale would return to the shareholders in the liquidation.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 37

MODIFICATIONS TO CORPORATE DISTRIBUTION RULES

John P. Warner, Esq.
Samuel M. Maruca, Esq.
Silverstein and Mullens
Washington, D.C.

I. Distributions of Appreciated Property by C Corporations

A. Overview

Section 631(c) of the 1986 TRA continues the trend of requiring corporations to recognize gain on non-liquidating distributions. Although non-liquidating corporations have since 1969 been subject to a general rule requiring recognition of gain on their distribution of appreciated assets,[1] several exceptions to gain recognition have been available. Beginning with the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), however, these exceptions to gain recognition have been continually narrowed. In general, after 1986, gain on non-liquidating distributions is subject to tax.

B. Removal of Exceptions to Gain Recognition

Under §311 prior to the 1986 TRA,[2] distributing corporations did not recognize gain on non-liquidating distributions if such distributions were (i) to non-corporate shareholders in partial liquidation or as a dividend of non-inventory property which had been used by the corporation in a 5-year business, (ii) to more-than-10% long-term shareholders and consisted of more-than-50% of the stock of a corporation engaged in a 5-year business, (iii) §303 redemption distributions, (iv) to private foundations in redemption of certain excess business holdings, or (v) by regulated investment companies (CRICs) in redemption of the stock of shareholders on demand.

Section 631(c) of the 1986 TRA eliminates all but the last of these exceptions to gain recognition by distributing corporations so that such non-liquidating distributions will generate a tax both to the distributing corporations and to the distributee shareholders. (The RIC distribution exception is preserved by Act §631(e)(11), adding Code §852(b)(6). For purposes of computing the distributing corporation's gain on these distributions, the fair market value of any asset distributed is considered to be no less than the amount of any liability to which the distributed property is subject or which the distributee assumes.[3] Non-liquidating distributions of obligations of the distributing corporation continue to avoid the general rule of gain recognition. *See* revised §311(b)(1)(A).

Unlike the 1986 TRA rules governing liquidating distributions,[4] Code §311 as revised continues the non-recognition of loss to distributing corporations on non-liquidating distributions. The 1986 TRA eliminates the pre-Act rule[5] of gain recognition attributable to LIFO reserves on the distribution of inventory assets but provides that all corporations using the LIFO inventory method must increase or decrease their earnings and profits by the annual increase or decrease in the excess of its inventory as accounted for under LIFO over what such inventory would be accounted for under a FIFO method.[6]

Comment: As a result of these changes, it will be more expensive to redeem the stock of individual shareholders using appreciated property. Where such shareholders have their stock redeemed, corporations will have a greater incentive to use either cash or corporate notes or, if possible, to structure such transactions to qualify for §355 treatment.

Although, as a general rule, §355 distributions remain tax free to the distributing corporation, Act §631(d)(1) enacts Code §367(e)(1), which provides that §355 distributions by U.S. corporations to foreign persons will cause the distributing corporations to recognize gain to the extent provided under Code §367 principles. Note that temporary regulations regarding transfers of stock or securities in "outbound" §351 exchanges provide that transfers by U.S. transferors of stock to foreign corporations are not taxable where the U.S. transferors own non-controlling interests in the foreign corporations and in certain other instances where the transferors agree to recognize, at the time the transferee disposes of the stock or securities transferred, gain realized on the exchange.[7]

---

[1] *See, e.g.*, former Code §311(d)(1), as amended by P.L. 98-369, §54(a).
[2] Former Code §311(d)(2).
[3] Revised Code §311(b)(2), providing that rules "similar to" the rules of revised Code §336(b) apply for purposes of §311.
[4] Revised Code §336(a). For a discussion of the rules governing the treatment of corporations on liquidating distributions, see Chapter 36, *supra*.
[5] Former Code §311(b).
[6] Revised Code §312(n)(4), as enacted by 1986 TRA §631(e)(1).
[7] *See* Temp. Regs. §1.367(a)-3T(c), (f) and (g) (promulgated before enactment of the 1984 TRA).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

C. *Effective Date*

In general, under Act §633(a)(3), the revised rules governing gain recognition are effective for non-liquidating distributions made after December 31, 1986. A somewhat inartfully drafted transition rule contained in concurrent resolutions passed in the 99th Congress by both the Senate and the House to correct errors in the conference report to the 1986 TRA would apparently have permitted "qualified corporation[s]" — corporations more than 50% of whose stock as of August 1, 1986 and at all times thereafter was held by ten or fewer individuals, estates and certain trusts and which corporations have a fair market value no greater than $5,000,000 — to avoid the revised rules at least with respect to pre-1989 non-liquidating distributions of property other than ordinary income or short term capital assets and installment obligations. For such closely held corporations having a fair market value between $5,000,000 and $10,000,000, availability of the pre-1986 TRA exceptions to recognition would have been reduced as the value of the corporation approached $10,000,000 and would have been unavailable thereafter. *Cf.* Act §633(d) (containing transitional rules for comple liquidations of "qualified corporations").

Unfortunately, no concurrent resolution containing technical changes to the TRA 1986 was enacted by the 99th Congress. As a result, nothing in the law as passed would prevent gain recognition even by "qualified corporations" on their pre-1989 non-liquidating distributions. This omission may, however, be corrected by technical corrections legislation.

II. Reduction in Stock Basis for Nontaxed Portion of Extraordinary Dividends

A. *Background*

Prior to enactment of the Tax Reform Act of 1984, corporations with short-term capital gain, otherwise taxable at a maximum rate of 28% under former §1201(a), could effectively convert it into income taxable at a maximum rate of 6.9% by purchasing stock in another corporation that was about to pay a dividend, receiving the dividend and selling the stock at a loss. If the corporation acquired the stock after the dividend was declared, the price it paid for the stock would include the full value of the dividend. The corporation then could deduct 85% of the dividend, under former §243(a)(1), provided it held the stock for at least 16 days (91 days for preferred stock),[8] with the result that the maximum tax on the dividend would be 6.9% (*i.e.*, 46% of 15%). Since the dividend value was reflected in the corporation's basis but not in the post-dividend stock value, the corporation could sell the stock after receiving the dividend and generate a loss that it could use to offset short-term capital gains from other capital transactions.

The 1984 Act added §1059, which provides that if a corporation received an "extraordinary dividend" on stock and disposed of the stock before holding it for more than a year, the basis of the stock would be reduced by the amount of the untaxed portion of the dividend. Former §1059(a). An extraordinary dividend was defined in §1059(c) in terms of the size of the dividend in relation to the shareholder's adjusted basis in its stock. The untaxed portion of the dividend was defined in §1059(b) as the excess of the value of the distribution over the taxable portion of the distribution.

B. *Overview of Amendments*

The 1986 TRA provisions enact an alternative test to determine whether a dividend is extraordinary. The taxpayer may elect to apply either the percentage-of-adjusted basis test under pre-1986 TRA law or a test based on the stock's fair market value as of the day before the ex-dividend date. The 1986 TRA changes the holding period required to avoid the basis reduction rule from more than one year prior to sale to more than two years before the dividend announcement date.

The Act confers special treatment on certain qualifying preferred stock, providing relief for transactions in which there is no potential for effectively purchasing a dividend that accrued prior to the purchase date. It also expands the term "extraordinary dividend" to include any distribution to a corporate shareholder in partial liquidation of the distributing corporation and any non-*pro rata* redemption of stock.

In certain respects, pre-existing law governing extraordinary dividends has been liberalized.

C. *Detailed Analysis*

1. *Determination of Extraordinary Dividend*

A dividend is considered extraordinary if the amount of the dividend equals or exceeds 10% (5% when the stock is preferred as to dividends) of the taxpayer's adjusted basis in the stock.[9] The Act provides an alternative test, available at the taxpayer's election: under §1059(c)(4), if the taxpayer establishes to the satisfaction of the Secretary of the Treasury the fair market value of any share of stock [10] as of the day before the ex-dividend date [11] the taxpayer may base the extraordinary dividend determination upon whether the dividend equals or exceeds 10% of this value instead of 10% of the adjusted basis of the stock.[12]

Note: The taxpayer will choose the fair market value alternative when the amount of the dividend received, multiplied by ten, is less than the fair market value as of the relevant date, but is equal to or greater than the taxpayer's adjusted basis in the stock.

Example: Corporation X buys common stock of corporation Y on January 1, 1988, for $20 a share. On January 1, 1990, Corporation Y's board of directors declares a $5 per share dividend, to be paid February 1. On January 31, 1990, Corporation Y stock has a fair market value of $51 a share, and Corporation X establishes this fact to the satis-

[8] *See* §246(c), prior to its amendment by P.L. 98-369, the Tax Reform Act of 1984. For a discussion of changes in the dividends received deduction provisions, see Chapter 34, section II.

[9] §1059(c).

[10] Presumably, the Secretary will promulgate regulations detailing the manner in which the fair market value rule is to be elected and its availability demonstrated by the taxpayer. *See* Code §1059(f). The proof of value will be difficult where the stock is not publicly traded.

[11] The term "ex-dividend date" means the date on which the share of stock becomes ex-dividend. Code §1059(d)(4).

[12] Act §614(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

faction of the Secretary. Applying the percentage-of-adjusted-basis test, and assuming Corporation X has an adjusted basis of $20, the distribution would be an extraordinary dividend, since the amount of the dividend ($5) exceeds the product of the adjusted basis ($20) and the applicable percentage (10%), or $2. Corporation X may instead apply the fair market value test. Under this standard the distribution is not an extraordinary dividend, since the amount of the dividend ($5) is less than the product of the applicable percentage (10%) and the fair market value of the stock ($51).

According to the Senate Finance Committee Report, the purpose of the alternative fair market value test is to mitigate application of the basis reduction rule when a taxpayer can demonstrate that the stock has appreciated significantly since the date of the taxpayer's original investment.[13] The utility of the new test will depend in large measure on the valuation standards imposed by the Secretary.

2. Holding Period

Instead of a one-year post-acquisition holding period, the 1986 TRA provides that extraordinary dividends will trigger basis reduction if the taxpayer has not held the stock for more than two years before the dividend announcement date.[14] The term "dividend announcement date" means the day on which the distributing corporation declares, announces, or agrees to the payment of the dividend, whichever is the first to occur.[15] Thus, if there is a formal or informal agreement to pay the particular dividend prior to the declaration date, the date of this agreement will be considered the dividend announcement date for purposes of computing the two-year period.[16]

The Conference Report clarifies that whether an agreement to pay dividends exists will be determined based on all the facts and circumstance of each case. The Conference Agreement stipulates that, in general, an agreement in a joint venture arrangement that "dividends will be paid as funds are available" is not an agreement to pay a particular dividend in the absence of facts showing a "particular expectation" of a large dividend following acquisition of an interest in the venture.[17]

Act §1014(d), adding Code §1059(d)(7), prescribes an exception to the two-year holding period, applicable when three criteria are met. No extraordinary dividend will arise if (1) the stock was held by the taxpayer for the entire period the distributing corporation (and any predecessor corporation) was in existence, (2) except as provided in regulations, the only earnings and profits of the distributing corporation were those accumulated during this period, and (3) the application of the exception is not inconsistent with the purposes of §1059.

3. Qualifying Preferred Stock

Section 1059(e)(3) provides for special treatment of certain "qualifying preferred dividends."[18] In general, such dividends are treated as extraordinary dividends only to the extent the dividends the taxpayer receives during the period exceed the dividends it actually "earns." This provision is intended to provide relief to the extent that there is no potential for effectively purchasing a dividend that accrued prior to the date of purchase.[19]

Note: The special rule does not apply unless the dividend would otherwise be treated as extraordinary under the general rule of §1059(c)(2).

Section 1059(e)(3)(C)(i) defines the term "qualified preferred dividend" as any dividend payable with respect to stock that (1) provides for fixed (*i.e.*, unvarying) preferred dividends payable not less frequently than annually and (2) is not in arrears as to dividends when it is acquired by the taxpayer.

Once it is determined that the dividends are qualified preferred dividends, the taxpayer must apply the operative test to determine whether the dividends are extraordinary. This test is stated in the negative. A qualified preferred dividend will be treated as an extraordinary dividend only if (1) the "actual rate of return" on the stock exceeds 15% or, (2) if the actual rate of return is 15% or less and the taxpayer disposes of the stock within five years of acquisition, to the extent that the actual rate of return exceeds the "stated rate of return" on the stock. Code §1059(e)(3)(A). Stated otherwise, in the case of stock paying qualified preferred dividends at the rate of not more than 15%, such dividends are extraordinary only to the extent that dividends received exceed dividends payable at the stated rate.

A corporation determines whether its dividends received exceeds its dividends earned by first computing its "actual dividend rate." The actual dividend rate is the average annual amount of dividends received[20] during the period the corporation owned the stock, computed as a return on the lesser of (1) the corporation's adjusted basis and (2) the stock's liquidation preference.[21] This amount is then compared to the "stated dividend rate," defined as the rate of return represented by the annual fixed preferred dividends payable on the stock, also expressed as a percentage of the lesser of adjusted basis or liquidation preference.[22] To the extent the actual dividend rate exceeds the stated dividend rate, a portion of each dividend received will warrant extraordinary dividend treatment, and basis will be reduced by the untaxed part of the portion deemed extraordinary.[23]

[13] *See* S. Rep. No. 313, 99th Cong., 2d Sess. 250 (1986) ("Senate Report").
[14] Act §614(a)(1); Code §1059(a).
[15] Act §614(a)(2); Code §1059(d)(6).
[16] *See* H.R. Rep. No. 841, 99th Cong., 2d Sess. II-164 (1986) ("Conference Report").
[17] *Id.*
[18] Act §614(e).
[19] *See* Conference Report at II-164-65. Code §1059(e)(3)(A).
[20] The legislative history, not the statute, provides for computation on an annual basis. *See* Conference Report at II-165. The Conference Report also clarifies that dividends are considered received if deemed received under Code §305. *Id.*
[21] Code §1059(e)(3)(B)(i). The Conference Report, at II-164 n.1a, specifies that a liquidation preference is to be computed without regard to any dividend arrearages.
[22] Code §1059(e)(3)(A)(ii).
[23] Code §1059(e)(3)(A)(ii). *See* Conference Report at II-165.

The Conference Report provides the following example of the special treatment for qualifying dividends:

> "[A]assume that on January 1, 1987, a corporation purchases for $1,000 ten shares of preferred stock having a liquidation preference of $100 per share and paying fixed preferred dividends of $6 per share to shareholders of record on March 31 and September 30 of each year. If the taxpayer does not elect to have the special rule apply, the basic rule would generally require the taxpayer to reduce the basis in the stock by the untaxed portion of each dividend received prior to the expiration of the two-year holding period. This is because a dividend exceeding 5% of adjusted basis (or fair market value, if shown to the satisfaction of the Secretary) paid semi-annually is an extraordinary dividend under the general rule. However, the special rule will apply to the stock. Under this provision, the taxpayer's stated dividend rate is 12% ($12/$100). If the taxpayer sells the stock on October 1, 1988 (after holding the stock for 1.75 years) and no dividends in excess of the fixed preferred dividends have been paid, its "actual dividend rate" will be 12.7% ($240/$1000 divided by 1.75). This 13.7% exceeds the 12% stated dividend rate by 1.7. This excess, as a fraction of the actual dividend rate, is 12.4% (1.7 divided by 13.7). Accordingly, each of the dividends will be treated as an extraordinary dividend described in §1059(a) to the extent of 0.74 per share ($6 × 12.4%). However, if the corporation does not sell the stock until January 1, 1989, and no dividends in excess of the fixed preferred dividends have been paid, its "actual dividend rate" will be 12% ($240/$1000 divided by 2.0). This does not exceed the stated dividend rate; accordingly, no portion of any dividend will be treated as an extraordinary dividend." [24]

In the absence of the special rule, under the basic definition of extraordinary dividend, preferred stock paying a dividend of 5% of the adjusted basis (or fair market value) of the stock would require a basis adjustment.[25] If the stock paid four quarterly 2½% dividends, however, none of the dividends generated would be extraordinary.[26]

4. Partial Liquidations and Non-Pro Rata Redemptions

The 1986 TRA expands the definition of "extraordi nary dividend" to include any redemption of stock that is part of a partial liquidation of the redeeming corporation, or that is not *pro rata* as to all shareholders.[27]

a. Partial Liquidations

For the purposes of §1059(e), a distribution is treated as in partial liquidation if it satisfies the requirements of §302(e).[28] Thus, a distribution is in partial liquidation if the distribution (1) is not essentially equivalent to a dividend and (2) is pursuant to a plan and occurs within the taxable year in which the plan is adopted, or the succeeding taxable year.

The Treasury Department will have the authority to require the distributing corporation to advise its shareholders as to the character of the distribution, since the determination of whether a distribution is in partial liquidation is made at the corporate rather than the shareholder level.[29] The Conference Report expresses the conferees' intention that there will be a presumption, rebuttable by clear and convincing evidence, that the distributing corporation's characterization is correct, and that the Treasury Department may require a taxpayer taking a contrary position to disclose on its return its reasons for doing so.[30]

This new provision applies to distributions in partial liquidation regardless of the taxpayer's holding period, and regardless of the size of the distribution.[31]

b. Non-Pro Rata Redemptions

Any non-*pro rata* redemption of stock, irrespective of the holding period or the size of the distribution, is considered an extraordinary dividend under revised §1059.[32]

5. Specific Exceptions and Additional Rules

The 1986 TRA liberalizes the extraordinary dividend provisions by excluding "qualifying dividends" as defined in §243(b)(1), except to the extent provided otherwise in regulations.[33] Generally, qualifying dividends are those received from an affiliate if the group has made a §243(b)(2) election and the distribution is out of earnings and profits for a year during the entirety of which the distributing and recipient corporations were affiliated.

Under pre-1986 TRA §1059(a), if the amount of an extraordinary dividend exceeded the taxpayer's stock basis, the excess was recognized immediately as gain. Revised §1059(a)(1) and (2) soften this rule. Under these provisions, the basis of stock paying on extraordinary dividend is reduced by the nontaxed portion of the dividend, but not below zero. Recognition of gain on nontaxed portions of extraordinary dividends is deferred until sale or other disposition of the stock. *See* §1059(a)(2).

According to the Conference Report, the Conferees expect that the amount of earnings and profits resulting from gain on the disposition of stock should be determined without regard to basis adjustments made under §1059. The intention of the Conferees is to prevent the double inclusion in earnings and profits of the untaxed portion of extraordinary dividends.[34]

6. Effective dates

The revised provisions generally are effective for dividends declared after July 18, 1986, with the exception of non-*pro rata* redemptions and distributions in partial liquidation, which are not subject to the revised rules unless declared after the date of enactment (October 22, 1986).[35]

[24] Conference Report at II-165 (footnote omitted).
[25] *See* Code §1059(c)(2)(A).
[26] *Id.*
[27] Act §614(e)(1); Code §1059(e)(1).
[28] Code §1059(e)(1)(A).
[29] *See* Conference Report at II-166.
[30] *Id.* n.3.
[31] Code §1059(e)(1).
[32] Code §1059(e)(1)(B).
[33] Act §614(e); Code §1059(e)(2).
[34] *See* Conference Report at II-166.
[35] Act §614(f).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

However, the aggregation rule of §1059(c)(3) does not encompass pre-July 19, 1986 dividends. Thus, dividends declared prior to that date will not be treated as part of dividends declared after that date. *See* Act §614 (f)(2).

III. Effect on Earnings and Profits of Appreciated Property Distributions

A. Background

Section 312(a) provides that, as a general rule, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation must be reduced by the sum of the amount of money, the principal amount of the obligations of the corporation, and the adjusted basis of other property so distributed. Under pre-1986 TRA §312(b), on a distribution of appreciated inventory assets, earnings and profits must be increased by the amount of the appreciation and decreased by the lesser of (1) the fair market value of the inventory assets distributed and (2) the earnings and profits, as increased by the distribution. In effect, the distribution of inventory results in a reduction of earnings and profits in an amount equal to the basis of the inventory, and dividend income to the distributee in the amount of the appreciation.

Pre-1986 TRA §312(c), provided for adjustments to earnings and profits computations under §312(a) and (b) to reflect (1) liabilities attaching to distributed property or assumed by the distributee-shareholder and (2) any gain recognized by the corporation on the transaction. Under this rule, to the extent that the corporation recognized gain on a distribution, earnings and profits were reduced.[36]

In the Tax Reform Act of 1984, Congress added §312(n), which includes a number of significant changes to the earnings and profits computation rules. The purpose of these provisions is to ensure that a corporation's earnings and profits account reflects more closely its economic income.[37]

Among the §312(n) rules is a requirement that earnings and profits be increased by the amount of gain that would be recognized by the corporation on a distribution of appreciated property if §311(d)(2) did not apply.[38] §311(d)(2) also included certain other specific types of distributions.[39]

Section 312(n) also contains a provision to the effect that upon a redemption to which §302(a) or §303 applies, the earnings and profits of the distributing corporation are to be charged in an amount that is not in excess of the ratable share of accumulated earnings and profits attributable to the redeemed stock. §312(n)(8). The 1984 Act failed to prescribe an effective date for this rule, however.

Finally, the 1984 Act provided that with respect to a foreign corporation that for any taxable year derives less than 20% of its gross income from United States sources, certain of the §312(n) rules apply only in the case of taxable years beginning after December 31, 1985.

B. TRA 1986 Amendments

The 1986 TRA amends §312(b) in its entirety. Under new §312(b), on a distribution by a corporation, with respect to its stock, of any property (not merely inventory property) the fair market value of which exceeds its adjusted basis, the earnings and profits of the corporation must be increased by the amount of the excess and decreased by the fair market value of the distributed property.[40] For purposes of §312(a) and §312(b) as revised, the adjusted basis of distributed property is its adjusted basis as determined for earnings and profits computation.

Example: Corporation X has no accumulated or current earnings and profits. Corporation X in 1985 distributes property having a zero basis and a $1,000 fair market value in a § 311(d)(2) transaction. Corporation X recognizes no gain, but its earnings and profits account is increased to $1,000 (resulting in a dividend to the distributee-shareholder), and then reduced to zero. *See* House Report at 897.

The 1986 Act adds three additional amendments to §312. First, the 1986 Act repeals pre-1986 TRA §312(c)(3).[41] Accordingly, the computation of earnings and profits is to be made without adjustment for gain recognized by the corporation (thereby ensuring two levels of tax on appreciated property distributions). Second, pre-1986 TRA §312(n)(4) [relating to adjustments to earnings and profits for certain untaxed appreciation of distributed property] is repealed;[42] the amendment to the general rule of §312(b) renders it unnecessary. Finally, the Act provides that in the case of a foreign corporation described in §312(k)(4), §312(n)(4) and (6), as amended, (relating to earnings and profits adjustments for LIFO recapture and completed contract method of accounting) shall apply only in the case of taxable years beginning after December 31, 1985, and §312(n)(5), as amended, (relating to installment sales accounting) will apply only in the case of taxable years beginning after December 31, 1987.[43]

C. Effective Dates

The amendments to §312 apply as if they had been included in the Tax Reform Act of 1984 revisions to §312.[44] Thus, the amendments apply to taxable years beginning after September 30, 1984.[45]

Note: Revised §312(b) applies, by its terms, to any distribution of appreciated property. This would appear to

[36] *See* Regs. §1.312-3.
[37] S. Rep. No. 169, 98th Cong., 2d. Sess. 198 (1984).
[38] §312(n)(4). Under §311(d)(2), before its amendment by the 1986 Act, a corporation did not recognize gain on appreciated property distributed with respect to "qualified stock" (*i.e.*, stock held by a non-corporate shareholder who held at least 10% in value of the outstanding stock during the lesser of the five-year period ending on the distribution date or the duration of the corporation) if the distribution is described in §302(b)(4) or is a dividend of property (other than accounts receivable or inventory) that was used by the distributing corporation in an active business for the preceding five years.
[39] The 1984 Act contained no provision, however, providing for a reduction in earnings and profits by the amount of the distribution (or by the adjusted basis of the distributed property).

[40] Act §1804(f)(1)(A).
[41] Act §1804(f)(1)(B).
[42] Act §1804(f)(1)(D).
[43] Act §1804(f)(1)(E); Code §312(n)(8)(A) and (B).
[44] Act §1881. *See also* Act §1804(f)(3).
[45] P.L. 98-369, §61(e).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

include distributions pursuant to one-month liquidations under §333. *See* Rev. Rul. 79-149, 1979-1 C.B. 132 (breeding animals not "inventory assets" under §312(b); distribution in §333 liquidation does not require increase to earnings and profits). Thus, appreciation on property distributed in a §333 liquidation in taxable years beginning after September 30, 1984, would be taxed to the shareholders at dividend rates. The House Report specifies, however, that the rules for computing earnings and profits in a §333 liquidation are not to be affected by the §312(b) revisions,[46] but this language does not appear in the Conference Report. In Rev. Rul. 87-1, reprinted in 5 *Tax Mgmt. Wkly. Rept.* 1596 (Dec. 29, 1986), the IRS followed the House Report and announced its position that the §312(b) revisions do not apply to §333 liquidations; accordingly, the IRS concluded that pre-1986 TRA §312(b) and (c) apply to such liquidations.

IV. Distribution of Partnership and Trust Interests

A. Background

Section 75 of the Tax Reform Act of 1984 added new §386, which prescribes a "look-through" rule where a corporation distributes a partnership or trust interest to its shareholders, or sells or exchanges such an interest in a §337 liquidation. The distribution or sale must be treated as if it included a distribution or sale of the corporation's proportionate share of the "recognition property" of the partnership or trust.

In a non-liquidating distribution, recognition property includes property the distribution of which triggers recognition under §311 or §336, including LIFO inventory, property subject to liabilities in excess of basis, appreciated property distributed in redemption of stock and installment obligations subject to §453B (relating to gain or loss on the disposition of installment obligations).[47] In the case of a distribution in complete liquidation, only LIFO inventory and installment obligations trigger recognition.[48] On a liquidating sale under §337, recognition property consists of property described in §337(b), that is, inventory, installment obligations arising from the disposition of inventory and installment obligations attributable to sales of non-inventory property prior to the adoption of a plan of complete liquidation.[49]

Under these rules a corporation might recognize gain on the distribution or sale of a partnership or trust interest even though the corporation has no built-in economic gain attributable to recognition property. Thus, if a corporation purchases at fair market value an interest in a partnership holding only appreciated inventory, but the partnership has no §754 election in effect, the corporation would recognize gain on an immediate non-liquidating distribution of the interest though the corporation has realized no economic benefit.

[46] H. Rep. No. 426, 99th Cong., 1st. Sess. 897 (1985).
[47] Code §386(c)(1).
[48] *Id.*
[49] Code §386(c)(2).

The 1984 TRA also added a provision to the effect that, for purposes of §§708, 743 and any other Subchapter K provisions specified in regulations, any distribution not otherwise treated as an exchange shall be treated as an exchange.[50] Although the conferees described this rule as applying only to distributions of partnership interests,[51] the statute is not itself so limited.

B. Limitation on Recognition of Gain

Under new §386(d), added by §1805(c)(1) of the 1986 Act, in any distribution to which §311 applies, the amount of gain recognized under §386(a) shall not exceed the gain that would have been recognized if the partnership interest had been sold at its fair market value. For example, a corporation that acquired a partnership interest at fair market value and immediately distributed the interest in a §311 transaction would recognize no gain, regardless of the basis of the partnership property attributable to the interest.[52]

Note: New §386(d) applies only in the case of a nonliquidating distribution to which §311 applies. Relief is not available in a liquidating distribution or §337 sale.

Note that new §386(d) will not insulate a distributing corporation from depreciation recapture under §751. Thus, a corporation that distributes a partnership interest will recognize depreciation recapture with respect to the partnership's recapture property attributable to the interest, even if the corporation derived no benefit from the depreciation deductions giving rise to the recapture income.[53]

Section 386(d) confers upon the Secretary the authority to disregard built-in loss on property contributed by a corporation to a partnership "for the principal purpose of recognizing such loss on the distribution." The intent of the Ways and Means Committee is that a corporation not be permitted to reduce gain inherent in a distributed partnership interest by "netting" gain and loss property.[54] The House Report notes that §311 does not permit such "netting" (since only gain is recognized under that section).[55]

The 1986 Act clarifies §761(e) by amendments limiting the reach of the provision to distributions of partnership interests.[56] The Secretary is authorized to provide exceptions to these rules. According to the Senate Report, it is intended that a distribution of a partnership interest by an estate or testamentary trust by reason of the death of a partner not be treated as a sale or exchange for purposes of §708(b) (relating to termination of a partnership).[57]

C. Effective Date

The amendments to §§386 and 761(e) apply with respect to distributions, sales and exchanges made after March 31, 1984, in taxable years ending after that date.[58]

[50] Code §761(e).
[51] *See* H.R. Rep. No. 861, 98th Cong., 2nd Sess. 864 (1986).
[52] *See* House Report at 905.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] Act §1805(c)(2).
[57] *See* S. Rep. No. 313, 99th Cong., 2d Sess. 924 (1986).
[58] Act §1881.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 38

SPECIAL CORPORATE PROBLEMS

John P. Warner, Esq.
Samuel M. Maruca, Esq.
Patrick G. Dooher, Esq.
Silverstein and Mullens
Washington, D.C.

I. Certain Built-in Gains of S Corporations Subject to C Corporation Tax

A. Background

With the repeal by §631 of the 1986 TRA of the *General Utilities* doctrine for liquidating distributions, Congress extended the principle of double taxation to all forms of subchapter C corporate distributions where property is distributed outside of corporate solution. However, these provisions would not prevent farsighted shareholders of certain closely held C corporations from circumventing the corporate level tax on liquidating distributions by converting their corporations to subchapter S status, waiting three years and liquidating. In such a case, although Code §1363(d) requires recognition of gain on liquidating distributions of appreciated property by S corporations, only one level of tax would be imposed because the distributee shareholders would be entitled to increase the basis for their stock under §1367(a) by the amount of gain recognized by the corporation.

B. Tax on Built-In Gain of S Corporations

In order to prevent circumvention of the repeal of the *General Utilities* doctrine by C corporations converting to subchapter S status, the 1986 TRA §632 substantially revises Code §1374 to impose a tax on the "built-in gain" recognized by former C corporations during the first ten years after electing S corporation status. Under revised Code §1374, a tax equal to the highest rate of corporate tax is imposed on the taxable sale, exchange or disposition within ten years after conversion to S status of any asset — including inventory, goodwill and going concern value — held by the corporation on the date of the conversion to the extent of the appreciation in the value of such asset as of the date of conversion. The corporate taxpayer has the burden of proving that any asset disposed of during this ten-year period was not owned by it on the date of conversion or that any such asset had a lower fair market value on the date of conversion than on the date of disposition.[1]

1. Recognized Built-in Gain

The tax imposed by revised §1374(a) is imposed on the "recognized built-in gain" of a corporation that converts to S status pursuant to a post-1986 election. §1374(d)(2) defines "recognized built-in gain" as the gain recognized on the "disposition" within the "recognition period" of any asset unless the corporation can establish either that the asset was not owned by it on the date of conversion or that the gain recognized exceeded the gain inherent in the asset as of the date of conversion. The recognition period is defined in §1374(d)(3) as the ten-year period beginning with the first day of the first taxable year for which the corporation was an S corporation.[2]

a. Dispositions

In Announcement 86-128[3] the Service took a broad view of the term "disposition" for §1374 purposes and interpreted it to include not only sales or exchanges but also "other income-recognition events that dispose of or relinquish a taxpayer's right to claim or receive income." Included among such events are a cash method taxpayer's collection of accounts receivable and completion of a long-term contract by a taxpayer using the completed contract method of accounting. Thus, in the Service's view, a cash method C corporation that converts to S status must, when the receivables are collected, be subject to a corporate level tax on the "fair market value" of the receivables as of the date of conversion. The burden will presumably be on the corporation to establish the appropriate discount factor on the receivables or else the full face amount of such receivables would be used for purposes of determining the amount of built-in gain.

Comment: The Announcement leaves open the question of whether the post-conversion collection of bills attributable to work in progress on the date of conversion to S status would be subject to the built-in gain tax, but the language of the Announcement seems broad enough to cover that situation. Presumably, the Service would consid-

[1] §1374(d)(2). Section references are to the Internal Revenue Code of 1986, unless otherwise indicated.

[2] Presumably, however, the ten-year period refers to ten calendar years, and not to ten taxable years.

[3] 1986-51 I.R.B. 22, reprinted in 5 *Tax Mgmt. Wkly. Rept.* 1519 (Dec. 5, 1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

er the post-conversion collection of installment payments to be "dispositions" for purposes of revised §1374.

b. Treatment of Inventory

The Service, in Announcement 86-128 [4] confirmed its interpretation that built-in gain on inventory items is subject to the built-in gain tax.

Comment: Where a corporation owns inventory or goods in process on the date of conversion to S status and later finishes production and/or sells the inventory through its own marketing efforts, the corporation will have an incentive to maximize the portion of overall gain attributable to the post-conversion activity while the Service will have an incentive to maximize the portion of the gain attributable to the corporation's pre-conversion activity. Thus, rules similar to the intercompany pricing rules of §482 (or §936) may be relevant in determining the amount of built-in gain, although the Service's posture may be quite different from that when applying §482 to a domestic manufacturer that has foreign affiliates performing finishing and/or marketing activities.

Since recognized built-in gain is generally limited to gain on assets owned on the date of conversion by a corporation that converts to S status, a corporation with substantial inventory could have difficulty in identifying when inventory items are disposed of. Announcement 86-128 eases the burden somewhat by providing that taxpayers may use their inventory accounting method to identify inventory on hand on the date of conversion and to determine when such inventory is disposed of. Thus, for example, a corporation using the LIFO method would presumably not be subject to built-in gain tax on its sale of inventory if, during the first ten years after conversion, its additions to inventory exceed its costs of goods sold each year. On the other hand, a corporation using the FIFO method would virtually always be subject to the built-in gain tax within a short time after conversion to S status.

c. Property Acquired in Nonrecognition Transactions After Conversion

Since revised §1374(d)(2)(A) provides that the built-in gain tax does not apply to gain recognized on any asset not owned on the date of conversion by a corporation converting to S status, a narrow interpretation of the statute would permit the tax to be avoided by a like-kind exchange or reorganization exchange of built-in gain property. Although the property received by the corporation would carry with it the gain inherent in the built-in gain property, §1374(d)(2)(A) by its own terms does not apply to property other than that actually held on the date of conversion.

In Announcement 86-128 [5] however, the Service stated that it would issue regulations to the effect that property received in exchange for built-in gain property in carryover or substituted basis transactions would inherit the built-in gain and recognition period that had been applicable to the original built-in gain property. Thus, in a post-1986 consolidation or "C" reorganization of an S corporation with built-in gain assets with or into a corporation not otherwise subject to the built-in gain rules,[6] the built-in gain assets of the acquired corporation would retain that status even though the acquiring corporation (or other party to a consolidation) had always been an S corporation or became one pursuant to a pre-1987 election. Similarly, if an S corporation transferred built-in gain assets in a §1031 like-kind exchange, the property received in exchange would inherit the amount of built-in gain attributable to the transferred property and the remainder of the original recognition period with respect to such property.

Example: On January 1, 1990, at which time it owns a rental apartment building with $100 fair market value and an adjusted basis of $60 and no other appreciated or loss assets, Corporation X converts from C to S status. On July 1, 1995, at which time the apartment building is worth $150 and Corporation X has a $30 basis in it, all of the assets of Corporation X are acquired in a reorganization qualifying for §368(a)(1)(C) tax free treatment by Corporation Y, a corporation that has been an S corporation throughout its existence. Under Announcement 86-128, if Corporation Y disposes of the building before January 1, 2000, in a year in which it generates other taxable income, Corporation Y will recognize $40 in built-in gain from the disposition.

Comment: Even under Announcement 86-128, the recognition period expires ten years after the conversion to S status so that a corporation may avoid the built-in gain tax on the disposition of property received in a like-kind exchange or reorganization for any built-in gain property if such exchange property is sold more than ten years after the corporation converts to S status, even if such sale is less than ten years after the like-kind exchange or reorganization.

Section 1374(c)(1), which limits application of the built-in gain tax to S corporations that convert from C status, provides that an S corporation and any predecessor corporation are treated as a single corporation for purposes of determining of whether a corporation is subject to revised §1374. Thus, an S corporation that is the survivor of a post-1986 merger with a C corporation or an S corporation that converted to S status pursuant to a post-1986 election would, at least with respect to assets acquired from the merging corporation, be subject to the built-in gain tax.

2. Net Unrealized Built-in Gain Limitation

The amount of income on which the revised §1374 tax may be imposed is limited under §1374(c)(2) by the "net unrealized built-in gain" of the former C corporation on the date of conversion to S status. §1374(d)(1) defines the term "net unrealized built-in gain" as the excess of the total fair market value of the corporation's assets over its aggregate adjusted basis of those assets at the time of conversion. Thus, assets which at the time of conversion have an adjusted basis in the corporation's hands in excess of their fair market value reduce the amount of net unrealized

[4] *Id.*
[5] *Id.*

[6] A merger involving such corporations would be covered by revised Code §1374(c)(1), which treats an S corporation and all predecessor corporations as a single corporation for determining whether the S corporation converted from C corporation status.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

built-in gain and thus the amount of gain potentially subject to tax under §1374.

Example: Corporation X converts from C to S status effective January 1, 1990. On that date, Corporation X owns machinery with a fair market value of $100 in which it has an adjusted basis of $60 and a warehouse building with a fair market value of $50 in which it has an adjusted basis of $70. Although there is $40 of built-in gain on the machinery, Corporation X's net unrealized built-in gain, and thus the amount of built-in gain on which it is potentially subject to tax under §1374, is $20 ($40 - $20).

Comment: As is true of many other provisions of the 1986 TRA, the net unrealized built-in gain limit places a premium on taxpayers' obtaining sound appraisals of corporation assets prior to conversion to S status.

Because loss assets owned at the time of conversion reduce the exposure to built-in gain tax, shareholders of corporations planning to convert to S status have an incentive to transfer loss assets to the corporation prior to conversion. However, in Announcement 86-128 [7] the Service stated that it would issue regulations providing that the contribution of loss assets to a corporation in contemplation of its conversion to S status would not reduce the corporation's net unrealized built-in gain in situations where avoidance of the built-in gain tax motivated the contribution. The Service stated that contributions of loss property within two years prior to the earlier of the date of conversion or the date of filing an S election would be presumed to have such a tax avoidance motive absent the showing of a "clear and substantial" relationship between the loss property and the current or future business of the corporation.

3. Offsets Against Recognized Built-in Gain

Where an S corporation has recognized built-in gain during the first ten years after its conversion from C status, the built-in gain tax is imposed on the lesser of the recognized built-in gain for the year or the amount of taxable income from all sources that the corporation would have if it were a C corporation.[8] Thus, even where an S corporation disposes of a built-in gain asset within ten years after conversion from C status, it would not be subject to tax on the gain to the extent that it recognized net losses from its other assets and operations during the taxable year. Thus, where feasible, it may be desirable to defer dispositions of built-in gain assets to years when the corporation anticipates other losses.

Example: On January 1, 1990, when it owns an apartment building with a $100 fair market value and a $60 basis and no loss assets or other built-in gain assets, Corporation A converts to S status. On July 1, 1992, when its basis in the building is $50, Corporation A sells the building for $100. During 1992, Corporation A recognizes a $30 loss from operations. Because Corporation A's net income for the year, $20 ($50 less $30) is less than the $40 built-in gain recognized with respect to the building, Corporation A recognizes only $20 of gain under §1374 with respect to the sale.

Comment: Because under §1374(c)(2), the amount of recognized built-in gain — even if not subject to tax — reduces the amount of net unrealized built-in gain subject to the §1374 tax, the use of net operating losses pursuant to §1374(b)(2) to offset the built-in gain subject to tax in a given year represents a permanent reduction in the amount subject to the tax.

Although the amount of recognized built-in gain subject to tax under revised §1374 may not be reduced by net operating loss carryovers from other S corporation years,[9] it is reduced by net operating loss carryovers from C corporation years.[10] The only tax credits allowable to reduce a built-in gain tax are those carried forward from C corporation years of the corporation.[11] It is not clear whether tax credit carryforwards from C corporations that merge into S corporations subject to built-in gain tax are available to offset the tax on built-in gain from the acquiring corporation's disposition of its built-in gain assets.[12]

4. Effect of Built-in Gain Tax

As was true of former §1374, revised §1374 imposes a corporation level tax on the corporation recognizing the built-in gain. In turn, the amount of built-in gain tax liability reduces the amount of the corporation's taxable income that is passed through to the corporation's shareholders under §1366(a).[13]

Although electing prior to 1987 to convert to S status or initially electing S status for a new corporation may be desirable in many cases, such election may have detrimental consequences where losses are expected and the corporation's activities are in part loss-generating rental activities or ownership of loss-generating trades or businesses in which the corporation and most of its shareholders do not materially participate. The shareholders of an S corporation are denied deductions for passive activity losses of the corporation to the extent those losses exceed the shareholders' passive activity income, even if the corporation has net income from active trades or businesses.[14] However, closely held C corporations may offset their net active income with passive activity losses.[15]

5. Comparison with Former §1374

The built-in gain tax is in many ways much broader than the tax imposed by former §1374. Former §1374 applied to capital gain recognized by a former C corporation, whereas revised §1374 applies to the disposition of even ordinary income assets. Former §1374 applied only to capital gain in excess of $25,000 and only if such gain represented more than 50% of the corporation's taxable income for the year of recognition, whereas revised §1374 applies regardless of the amount of built-in gain recognized

[7] *See* footnote 3, *supra.*

[8] §1374(b)(1).

[9] §1374(d)(4)(B).

[10] §1374(b)(2).

[11] §1374(b)(3).

[12] §1374(b)(3)(A) provides that the only tax credits available to offset the tax on recognized built-in gain are those described in §1374(b)(3)(B). §1374(b)(3)(B) refers only to business credit carryforwards arising in taxable years "for which the corporation was a C corporation."

[13] Revised §1366(f)(2).

[14] *See* §469(a), discussed in Chapter 17, *supra.*

[15] §469(e)(2). In general, a closely held C corporation is one more than 50% of whose stock by value is owned directly or indirectly by five or fewer individuals. *See* §§469(j)(1), 465(a)(1)(B), and 542(a)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

during the taxable year. Former §1374 applied only to gain recognized within three taxable years after a C corporation converted to S status, whereas revised §1374 applies to gain recognized within ten years after a C corporation converts to S status.

On the other hand, revised §1374 is narrower than former §1374 in so far as it subjects to a separate tax only gain attributable to periods prior to conversion to S status, whereas former §1374 subjected to a separate tax all gain recognized within three years after conversion to S status even if the gain was attributable entirely to post-conversion appreciation.

C. Effective Date and Transition Rules

1. In General

The tax is effective for taxable years beginning after 1986 but does not apply to corporations that converted to S corporation status pursuant to elections made before January 1, 1987 — even if the election were not effective under the rules of Code §1362(b)(3) until after December 31, 1986. Act §633(b). Therefore, even a corporation that files an S election on December 31, 1986 is not subject to revised Code §1374.

2. Relief for Qualified Corporations

The 1986 TRA §633(d)(8) provides for partial relief from the built-in gain tax of revised Code §1374 for certain small closely held corporations that convert to S status effective prior to 1989. Act §633(d)(8) provides that, for purposes of applying revised Code §1374, "rules similar to" those set forth in Act §633(d)(1) - (7) apply to each "qualified corporation" which becomes an S corporation pursuant to a post-1986 election that is effective for a taxable year beginning prior to January 1, 1989.[16] Because many, if not most, corporations eligible for qualified corporation status will also be eligible for S corporation treatment, an understanding of the qualified corporation transition rules applicable to corporations that convert to S status prior to 1989 pursuant to post-1986 elections is important for effective tax planning for closely held corporations.

a. Qualified Corporations

Transition relief from the built-in gain tax is available to a corporation that converts to S status prior to 1989 pursuant to a post-1986 election only if that corporation is a "qualified corporation." The 1986 TRA, in §633(d)(5) and (6), defines the term "qualified corporation" as any corporation: (1) more than 50% of the value of whose stock as of August 1, 1986 and all times thereafter is held by no more than ten individuals, estates and certain trusts; and (2) which has a fair market value of not more than $10 million.

For purposes of determining whether no more than ten qualified persons own more than 50% of the value of a corporation's stock, stock owned by all people related under §318(a)(1) is treated as owned by a single individual.[17] Thus, if two family groups — each consisting of a husband and wife, three children, and five grandchildren who each own 5% of the stock — own the stock of a corporation meeting the fair market value tests, the corporation is a qualified corporation. On the other hand, if a corporation valued at less than $10 million is owned 5% by each of twenty unrelated individuals (or siblings), it is not a qualified corporation because no ten shareholders actually or by attribution own more than 50% of the value of the corporation's stock.

b. Relief Available to Qualified C Corporations: The Analogue

An understanding of the likely form of relief for qualified corporations that convert to S status before 1989 pursuant to post-1986 elections requires an understanding of the relief available to other qualified corporations in complete liquidations. 1986 TRA §633(d)(1) - (7) provides that the corporate level recognition of gain on liquidating sales and distributions imposed by 1986 TRA §§631 through 633 [18] can be avoided in part by qualified corporations which liquidate before January 1, 1989. Relief is not available even for qualified corporations that liquidate prior to 1989 as to gain (or loss) realized with respect to ordinary income assets, capital assets held for not more than six months ("long term capital assets"), and installment obligations on which gain remains to be recognized.

Under the transition rule of §633(d)(1) - (7), corporations meeting the stock ownership requirements that were valued at no more than $5 million will fully avoid gain or loss recognition upon liquidating distributions, sales or deemed §338 sales on long term capital assets other than installment obligations, while corporations meeting the stock ownership requirements and valued at between $5 million and $10 million will avoid gain or loss recognition on such long term capital assets in a declining proportion as the value of such corporations approached $10 million.

c. Relief from Built-in Gain Tax

Although the description of the relief available for qualified corporations that are S corporations in Act §633(d)(8) as "rules similar to" the transition rules applicable to qualified corporations liquidating before 1989 is somewhat confusing, the Service in Rev. Rul. 86-141,[19] set forth its interpretation of this transition rule. The Service noted that qualified corporations converting to S status effective prior to 1989 pursuant to post-1986 elections would obtain relief analogous to the relief available with respect to pre-1989 liquidations of qualified C corporations even if such converted corporations did not liquidate prior to 1989 (or even within ten years after conversion). Determination of whether such a corporation meets the stock ownership and fair market value tests for qualified corporation status is made both as of August 1, 1986 and as of the date of conversion to S status.

---

[16] Since the election must be effective for the corporation's year beginning before 1989, and not merely made before 1989, a calendar year corporation's election must be effective for calendar year 1988. Therefore, the election must be made no later than March 15, 1988. *See* §1362(b)(1)(B).

[17] Act §633(d)(6)(B).

[18] Note that Act §633(d)(1) literally provides that relief is available only from corporate level gain recognition imposed by Act §633. However, Act §633 does not impose any tax; it merely provides effective dates and transition relief. The House and Senate-passed concurrent resolutions which were not enacted would have corrected this oversight. Presumably, a technical corrections bill will be enacted to clarify the intended relief.

[19] 1986-49 I.R.B. 6.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The relief afforded such qualified S corporations having a fair market value of $5 million or less on both August 1, 1986 and the date of conversion relief from the corporate level tax imposed by revised Code §1374 with respect to long term capital assets other than installment obligations. Relief available to qualified S corporations having a fair market value of between $5 million and $10 million on either of the applicable dates is partial relief from the built-in gain tax of revised §1374 with respect to long term capital assets other than installment obligations. A portion of built-in gain on such assets equal to a fraction, the numerator of which is the amount by which the fair market value of the corporation exceeds $5 million and the denominator of which is $5 million, is not eligible for relief and accordingly is subject to the revised §1374 tax.

Example: Corporation X is at all times owned 100% by A, an individual. On August 1, 1986, the fair market value of Corporation X is $5 million. Effective January 1, 1988, when its fair market value is $7 million and it owns $4 million in undeveloped investment land in which it has a $3 million basis, $2 million of property held for sale in the ordinary course of business in which it has $1.5 million basis, and $1 million in cash, Corporation X converts to S status. On July 1, 1988, Corporation X sells for cash the property held for sale in the ordinary course of its business for $2.5 million and on July 1, 1991, Corporation X is liquidated, distributing to A the investment land, the proceeds of the sale of the property held for sale, and the cash. Corporation X's built-in gain, determined as of the date of conversion, is all $500,000 of the gain, which at that time was attributable to the property held for sale in the ordinary course of its business and $400,000 [$1 million x ($2 million divided by $5 million)] attributable to the investment property. The $500,000 of built-in gain recognized on the 1988 sale of the property held for sale in the ordinary course of business subjects Corporation X to the §1374 tax in that year and the $400,000 of built-in gain attributable to the investment property subjects Corporation X to tax under revised §1374 on the 1991 liquidating distribution of the land.

Rev. Rul. 86-141 provides that former §1374 will apply to a qualified corporation converting to S status prior to 1989 pursuant to a post-1986 election to the extent that revised §1374 does not apply to any built-in gain by virtue of Act §633(d)(8).[20] Thus, if such a corporation recognizes within three years after the date of conversion more than $25,000 in net capital gain attributable to long term capital assets held at the date of conversion [21] as to which revised §1374 does not apply by virtue of Act §633(d), and such gain exceeds 50% of the corporation's taxable income for the year,[22] the corporation will be subject to §1374 as in effect prior to amendment by the 1986 TRA.

Example: Assume the same facts as in the preceding example except that Corporation X liquidates on December 31, 1990, rather than on July 1, 1991, and that Corporation X has no taxable income for the year 1990 other than amounts recognized on the liquidating distribution of the land, which is then worth $5 million. The corporation would thus have $2 million ($5 million land value less $3 million land basis) in taxable income for the year, of which all but the $400,000 in built-in gain would be subject to former §1374. Since the $1.6 million subject to former §1374 exceeds both $25,000 and 50% of Corporation X's 1990 taxable income, Corporation X would be subject to tax not only on the $400,000 built-in gain but also on all but $25,000 of the remaining $1.6 million gain.

Because the approaches of former §1374 and revised §1374 are not parallel, the Service's attempt in Rev. Rul. 86-141 to divine congressional intent as to the application of former §1374 to qualified corporations may lead to some strange results. For example, because former §1374 applies only where the corporation's net capital gain exceeds 50% of its taxable income for the year, many qualified C corporations converting to S status prior to 1989 pursuant to post-1986 elections, which corporations have a fair market value in excess of $7.5 million, will not be subject to former §1374 on the disposition of long term capital assets with built-in gain even if such dispositions occur within three years after conversion. On the other hand, such corporations with a value less than $7.5 million would in many cases be subject to the corporate level tax imposed by former §1374.

Example: Pursuant to a January 1, 1988 election, Corporation X, which is a qualified corporation with no liabilities and owning a single investment property worth $7.6 million in which the corporation has a $4.6 million basis, converts to S status effective January 1, 1988. Based on Rev. Rul. 86-141, 52% ($2.6 million divided by $5 million) of the gain inherent in the property, or $1.56 million, is subject to revised §1374 and the remaining 48%, or $1.44 million, is subject to the rules of former §1374. If, on December 31, 1990, a year in which it has no other taxable income or loss, Corporation X sells the property for $7.6 million, it will recognize $3 million in gain, of which $1.56 million will be subject to the built-in gain tax of revised §1374. Although the sale would be within three years after Corporation X's conversion to S status, the remaining $1.44 million in gain would apparently avoid the tax imposed by former §1374 because such gain would represent less than 50% of corporation X's taxable income (which would include the $1.56 million in gain subject to the rules of revised §1374) for the year. On the other hand, if, in the same example, the investment property were at all relevant times worth $7.4 million and Corporation X had a basis in it of $4.4 million, only 48%, or $1.44 million, of the built-in gain would be

[20] *See* H.R. Rep. No. 841, 99th Cong. 2d Sess. II-206 (1986)("Conference Report").

[21] Rev. Rul. 86-141 does not explicitly set forth rules governing property acquired by such a qualified corporation after the date of conversion to S status and sold or exchanged within three years after such conversion. However, given the legislative intention to replace the scheme of former §1374 with the scheme of revised §1374 and given the general January 1, 1987 effective date for repeal of former §1374, an attempt to apply former §1374 to such a sale or exchange should be subject to challenge.

[22] Former §1374(a)(1). In addition, the corporation's taxable income for the year must exceed $25,000. Former §1374(a)(2).

subject to revised §1374, while 52%, or $1.56 million, of such gain would be subject to former §1374. As a result, in the year of sale, more than half of Corporation X's taxable income would be represented by capital gain subject to former §1374 and thus that provision would appear to operate to subject the corporation to a tax in addition to that imposed by revised §1374.[23]

d. Relief from Recognition on Liquidation

The transition rules applicable partially to exempt qualified C corporations from gain recognition under revised Code §336 also apply to exempt partially S corporations from the gain recognition imposed under revised Code §1363(d) in respect of pre-1989 liquidations.[24] Prior to the effective date of its revision by the 1986 TRA, Code §1363(e) exempted S corporations from recognizing the gain realized on distributions in complete liquidations.[25] Code §1363(d), as a result of the amendment of Code §1363(e), imposes gain recognition on liquidating S corporations effective generally for post-July 31, 1986 liquidations (except for liquidations completed before January 1, 1987), but subject to transition relief. Because the corporate level tax imposed pursuant to revised Code §1374 applies only to dispositions of built-in gain assets on which gain is recognized under other Code provisions — that is, revised Code §1374 is not a gain recognition provision — qualified corporations that convert to S status pursuant to post-1986 elections, have built-in gain assets at the time of conversion, and liquidate prior to January 1, 1989, may avoid built-in gain tax, and — to the extent the rules of that provision are applicable — tax under former Code §1374.

Example: Corporation X is a calendar year corporation which on August 1, 1986 and on all times thereafter has a fair market value less than $5 million and whose stock is owned entirely by ten individuals. On March 1, 1987, the corporation's shareholders make a valid S election which is effective for the corporation's taxable year beginning January 1, 1987. As of January 1, 1987, Corporation X owns an investment property having a fair market value of $2 million in which it has a $1.5 million basis; property held for sale to customers in the ordinary course of its business worth $1 million in which it has an $800,000 basis; and no other assets with built-in gain or loss. Corporation X is completely liquidated on June 30, 1988, at which time the investment property is worth $2.2 million and the property held for sale to customers in the ordinary course of its business is worth $900,000. Corporation X has no net operating or investment income or loss for the period January 1, 1988 through June 30, 1988. Although the amount of net unrealized built-in gain attributable to Corporation X's assets is $700,000 [($2 million - $1.5 million) + ($1 million - $800,000)] and although the amount of net unrealized built-in gain attributable to the property held for sale in the ordinary course of its business is $200,000, Corporation X recognizes under Code §1363(e) only the $100,000 in gain as of the date of liquidation attributable to the property held for sale in the ordinary course of business. By operation of Act §633(d)(1) - (7) all gain attributable to the investment property avoids corporate level gain recognition on the liquidation because Corporation X was a qualified corporation that liquidated prior to 1989. Moreover, for the same reason, former §1374 does not apply even though gain on the investment property entirely avoided the revised §1374 tax and such realized gain, if it had been recognized, would have exceeded both $25,000 and 50% of Corporation X's taxable income for the year. Only $100,000 of the $200,000 in net unrealized built-in gain attributable to the property held for sale in the ordinary course of business was subject to corporate level tax because Corporation X's taxable income for the year had it been a C corporation would have been only $100,000.[26]

Comment: Even though at the time of the liquidation in the above example, the property held for sale in the ordinary course of business was worth only $100,000 in excess of Corporation X's basis in it, Corporation X would have been liable for the revised §1374 tax on all $200,000 of net unrealized built-in gain attributable to such property if the corporation had earned an additional $100,000 in taxable income during 1988 through operations or as a result of the distribution in liquidation of other inventory or property held for sale or of short term capital gain assets. On the other hand, Corporation X would have had no tax under revised §1374 if it had losses of $100,000 either from 1988 operations or as a result of the distribution in the liquidation of inventory, property held for sale in the ordinary course of business or short-term capital assets.[27]

II. Amendments to Personal Holding Company Rules

A. Background

Corporations that are classified as personal holding companies are subject not only to regular corporate income tax, but also to a 50% tax on personal holding company income that is not distributed to shareholders.[28] The purpose of this rule is to prevent individuals from using the corporate form to accumulate passive income and thereby avoid higher personal income tax rates. The statutory approach is to tax such income at the maximum marginal rate for personal income. The personal holding company tax applies to corporations that meet the definition of a personal holding company without regard to the intentions of the shareholders in forming the corporation.

A corporation is a personal holding company if, (1) at any time during the last half of the taxable year, more than

[23] It is possible that the Service could, in determining whether former §1374 applied to a qualified S corporation, reduce the corporation's taxable income by the amount of gain subject to tax under revised §1374 in the year. However, it would be difficult to read former §1374(a)(1) to reach such a result. It is also possible that the Service could include as "net capital gain," for purposes of former §1374(a)(1), built-in capital gain recognized and taxed under revised §1374. However, the logical extension of such an interpretation would be to impose both the tax called for under former §1374 and the tax imposed under revised §1374 to such built-in capital gain, which was clearly never intended.

[24] The qualified corporation transition rule of Act §633(d)(1) - (7) is not by its terms limited to C corporations. When the eagerly anticipated technical corrections bill clarifies the reference to the provisions which the qualified corporation exception modifies, relief to all qualified corporations from the corporate gain level gain recognition imposed by Act §631 through 633 should be provided. *See* footnote 18, *supra*.

[25] Former §1363(e)(1).

[26] Revised §1374(b)(1).

[27] Revised §1374(b)(1).

[28] §541.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

50% of its stock is owned by five or fewer individuals and (2) at least 60% of its adjusted gross income is "personal holding company income." [29] Personal holding company income is that portion of adjusted gross ordinary income consisting of dividends, interest, royalties and certain other types of income.[30]

A foreign personal holding company is a foreign corporation (1) over 50% of the total value of the stock of which is owned directly or indirectly by 5 or fewer individuals who are citizens or residents of the United States, and (2) at least 60% (50% with respect to certain corporations) of the gross income of which is foreign personal holding company income.[31] United States shareholders of a foreign personal holding company are treated as having received the undistributed foreign personal holding company income as a dividend on the last day of the corporation's taxable year.[32]

B. Rate Reduction

Act §104(b)(8) amends §541 by reducing the personal holding company tax rate from 50% to 38.5% in the case of taxable years beginning in 1987; a rate of 28% will apply for 1988 and later tax years. This amendment conforms the tax rate on undistributed personal holding company income to the maximum individual income tax rates under the 1986 Act.

C. New Exception For Computer Software Royalties

1. General Exclusion

Section 543(d), as added by Act §645(a)(2), excludes from the definition of personal holding company income "active business computer software royalties" received by a corporation in connection with the licensing of computer software.

In order to quality for the exclusion, the royalties must satisfy a four-part test, as follows:

(a) The royalties must be received by a corporation engaged in the active conduct of the trade or business of developing, manufacturing or processing computer software, and software from which the royalties are derived must be either developed or manufactured by the corporation (or its predecessor)[33] in connection with this trade or business, or directly related to the trade or business;[34]

(b) Such royalties constitute at least 50% of the corporation's ordinary gross income for the taxable year (the "50% test").[35]

(c) Deductions allowable under §§162, 174 and 195 that are properly allocable to the software trade or business must equal or exceed 25% of the corporation's ordinary gross income for the taxable year, or the average of these deductions for 5-taxable year period ending with such taxable year must be at least 25% of the average ordinary gross income for such period (the "25% test");[36] and in the case of a corporation that has not been in existence for at least 5 years, the period of its existence is to be substituted for the 5-taxable year period.

(d) The sum of (1) dividends paid (determined under §562), (2) dividends deemed paid (under §563(c)) and (3) consent dividends (determined under §565), equals or exceeds the amount, if any, by which personal holding company income exceeds 10% of ordinary gross income of the corporation for the taxable year.

Computer software royalties that satisfy these tests will not be considered personal holding company income for the purpose of determining whether a corporation is a personal holding company (*i.e.*, whether at least 60% of its adjusted gross income is personal holding company income). Thus, the higher the percentage of computer software royalties that constitute a corporation's adjusted gross income, the less likely it is that the corporation will be classified as a personal holding company.

Note: The rules for the exclusion of active business computer software royalties are structurally similar to the exceptions for rents, and mineral royalties and copyright royalties under §§543(a)(2), (3) and (4).

Act §645(a)(3) also modifies the definition of foreign personal holding company income by excluding active business computer software royalties.[37]

2. Special Rules

The general rules excluding active business computer software royalties from the definition of personal holding company income (and foreign personal holding company income) are subject to a number of refinements.

For purposes of the 25% test, new §543(d)(4)(B) stipulates that a deduction shall not be treated as allowable under §162 if it is specifically allowable under any other section. This rule prevents deductions allowable under §174 from being counted twice in applying the 25% test, and excludes deductions attributable to, for example, interest expense under §163.

Also, new §543(d)(4)(C) limits the deduction for compensation paid to principal shareholders for purposes of the 25% test. Thus, no deduction may be taken into account with respect to compensation for services rendered by the 5 shareholders holding the largest percentage (by value) of the outstanding stock of the corporation. Two special rules apply for this purpose. Deductions for compensation paid to less than 5% (by value) shareholders is not excluded,[38] and stock attribution solely by virtue of ownership by a partner (§544(a)(2)) is disregarded.[39]

For purposes of the 10% test, personal holding company income is computed by (a) excluding active business computer software royalties, and interest income of the corporation for any taxable year (i) which is in the 5-taxable year

[29] §542(a).
[30] §543.
[31] §552.
[32] §551(b).
[33] The House Report states that the term "predecessor" includes a partnership the partners of which developed software and transferred their partnership interests to the corporation in exchange for substantially all of the stock. H.R. Rep. No. 426, 99th Cong., 1st Sess., at 872. Presumably, this interpretation carries over to the Conference Report.
[34] §543(d)(2).
[35] §543(d)(3).
[36] §543(d)(4).
[37] §553(a)(1).
[38] §543(d)(4)(C)(i).
[39] §543(d)(4)(C)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

period beginning with the later of the first taxable year of the corporation or in which the software business was first conducted and (ii) during which the active business, 50% and 25% tests were satisfied, and (b) including adjusted income from rents and mineral royalties. §543(d)(5)(B).

Example: For its taxable year ending December 31, 1988 (its second taxable year), Corporation A has $100,000 of ordinary gross income of which $50,000 is received as royalties in connection with the licensing of computer software, $10,000 is interest income and $40,000 is rental income. Corporation A meets the active business and 25% tests for the taxable year. Provided that Corporation A distributes (or is deemed to distribute) at least $30,000 to shareholders, the royalty income will qualify as active business computer software royalties.

Finally, §543(d)(6) provides a special rule under which a taxpayer that receives software royalties will be deemed to have met the four-part test for active business computer software royalties if a member of the taxpayer's affiliated group of corporations meets the tests with respect to the software concerned. The §1504(a) definition of "affiliated group" applies for this purpose.[40]

D. Effective Dates

The exception for computer software royalties is effective for royalties received before, on, or after December 31, 1986.[41]

III. Technical Amendments Relating to Affiliated Group Definition

A. Background

1. Affiliated Group Definition

Prior to the amendments to Code §1504 made by the Tax Reform Act of 1984,[42] an affiliated group for purposes of determining eligibility to file a consolidated return was defined as one or more chains of "includible corporations" connected through stock ownership with a common parent corporation, which was itself an includible corporation, if (i) the common parent owned directly stock possessing at least 80% of the voting power of all classes of stock and at least 80% of each class of the nonvoting stock of at least one of the other includible corporations, and (ii) any other includible corporations were connected to each other or to the common parent under the same basic stock ownership test. For purposes of the stock ownership test, certain stock, such as nonvoting stock that was limited and preferred as to dividends, was not required to be considered.

Under the prior definition, a profitable corporation through the use of preferred stock, stock with varying voting rights, and stock with conversion features could acquire a net operating loss corporation even though the profitable corporation would own substantially less than 50%, in terms of value, of the stock of the loss corporation. To counter this abuse, as well as other perceived consolidated return abuses, the 1984 Tax Reform Act completely revised the definition of an affiliated group, to incorporate more stringent rules.[43] Under the revised definition, corporations must be linked together through ownership of at least 80% of the fair market of all outstanding stock, as well as 80% of the voting power of all classes of stock, in order to constitute an affiliated group. In determining stock ownership for this purpose, only nonvoting, nonparticipating stock that is limited and preferred as to dividends, redemption rights, and liquidation rights and that is not convertible into any other class of stock may be disregarded.

This revised, more stringent definition was generally effective for taxable years beginning after 1984.[44] However, under a grandfather rule,[45] the more stringent definition did not apply with respect to any corporation that on June 22, 1984, was a member of an affiliated group filing a consolidated return for such corporation's taxable year which included that June 22nd date, for purposes of determining whether that corporation continues to be a member of that group for taxable years beginning before January 1, 1988. The grandfather rule would cease to apply once a "sell-down" with respect to the corporation involved occurred.[46] A "sell-down" occurs if at any time after June 22, 1984, (i) more than a *de minimis* amount of stock of the corporation is sold or exchanged (including by redemption) or is issued other than in the ordinary course of business, and (ii) the requirements of revised §1504(a) are no longer satisfied after the sale, exchange, or issuance.

2. Includible Corporations — DISCs

As noted above, in order to qualify as a member of an affiliated group, a corporation must be an "includible corporation." Under existing law, a former DISC is not an includible corporation nor is a subsidiary of a former DISC. *See* Senate Report at 908. The reason for excluding a former DISC or former DISC subsidiary was that, prior to the 1984 Tax Reform Act, accumulated DISC income of a former DISC was included in the gross income of its shareholders as a dividend over a period of up to 10 years. Under Regs. §1.1502-14, if a former DISC and its parent could file consolidated returns, the former DISC's accumulated DISC income would be eliminated as a dividend from the parent's return and, consequently, would go untaxed. *Id.*

B. Analysis of Technical Corrections Affecting Affiliated Groups

1. Overview

The technical correction provisions of the 1986 Tax Reform Act,[47] (i) make a minor change in the definition of an affiliated group with respect to excludable stock, (ii) clarify the operation of the grandfather and sell-down rules, (iii) provide the common parent with an election to subject an affiliated group to the 1984 Act provisions regardless of the application of transition or grandfather rules, and (iv) and exclude any current DISC or other corporation having

[40] §543(d)(6)(B).
[41] Act §645(e).
[42] P.L. 98-369, §60.
[43] P.L. 98-369, §60, amending §1504.
[44] P.L. 98-369, §60(b)(1).
[45] P.L. 98-369, §60(b)(2).
[46] *Id.*, §60(b)(3).
[47] 1986 TRA, §1804(e).

accumulated DISC income derived after 1984 as a qualifying member of an affiliated group.

In addition, the technical corrections conform the definition of a subsidiary eligible to be liquidated under §332 with the more stringent 1984 Act definition of an affiliated group.

2. Excludable Stock Amendment

As amended by the 1986 Tax Reform Act, §1504(a)(4) excludes stock, if, among other things, the stock has redemption and liquidation rights which do not exceed the issue price of the stock (except for a reasonable redemption or liquidation premium). Prior to this amendment, such stock could be excluded only if the redemption and liquidation rights did not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par values). The purpose of this change is to make irrelevant the accounting treatment given to the issuance of the stock.[48]

3. Grandfather Rule Clarifications

The 1986 Tax Reform Act, §1804(e)(2), clarifies that the grandfather rule of 1984 TRA §60(b)(2) will cease to apply as of the first day after June 22, 1984, on which the corporation involved would not qualify as a member of the group under pre-1984 TRA law. Thus, for example, a corporation that ceased to be a member of a group on July 31, 1985, under prior law but which on July 31, 1985, and thereafter qualifies as a member of the group under the 1984 Tax Reform Act's more stringent rule continues to be treated as a member of the group.[49] Moreover, a "sell-down" will not be deemed to occur and, consequently, the grandfather rule will continue to apply, if the percentage interest by fair market value in the stock of the corporation involved held by other members of the group does not decline as a result of the sale, exchange, or redemption of such corporation's stock.[50]

4. Election of Post-1984 Act Rules

Another change made by the technical corrections of the 1986 Tax Reform Act is to allow a common parent of an affiliated group to elect to have the more stringent 1984 Act definition of an affiliated group apply to such group for taxable years beginning after December 31, 1983, regardless of any grandfather or transition rule. Any election, once made, is irrevocable.[51]

5. Includible Corporations — Exclusion of Post-1984 DISCs

With respect to the definition of an includible corporation, the 1986 Tax Reform Act revises §1504(b)(7) to provide that a DISC or any or corporation that has accumulated DISC income that is derived after December 31, 1984, is excluded. However, it is intended that this definitional change will not affect the status of certain S corporations with DISC subsidiaries that were grandfathered by the Subchapter S Revision Act of 1982.[52]

6. Sections 332, 337, and 338 Conforming Changes

Finally, the 1986 Tax Reform Act technical corrections make a series of conforming amendments to the definitions of a controlled subsidiary for purposes of §332 (relating to the tax-free liquidation of a subsidiary), §337(c)(3) (relating to certain distributee corporations), and §338 (relating to a qualified stock purchase for purposes of the deemed asset acquisition election of §338).

Prior to the 1984 Act, the definition of a corporation qualified as a subsidiary that could be liquidated tax-free under §332 was substantially similar to the general definition applied in determining whether the subsidiary was a member of an affiliated group under pre-1984 Tax Reform Act §1504. Although the 1984 Act revised §1504, it did not change §332. According to the Senate Finance Committee Report,[53] this created a discontinuity between the two sections that could produce unacceptable tax consequences. The Report gives the following example.

> *Example*: Assume that beginning on January 1, 1985, P corporation's ownership of S Corporation satisfied §1504 (as amended by the 1984 TRA) but not §332 and that, under §1504, P and S filed consolidated returns for the 1985 calendar year. Assume further that (i) S adopted a plan of complete liquidation in 1985, sold all its assets, and then liquidated within twelve months from the date the plan was adopted, and (ii) P did not liquidate. Because S's liquidation did not qualify under §332, pre-1986 TRA §337 would apply to accord nonrecognition to the asset sales. That would be an appropriate result so long as P were taxed on S's liquidation, and that would, in fact, generally be the result given the inapplicability of §332. However, since P and S filed a consolidated return, S's liquidation would not be taxable to P under Regs. §1.1502-14(b), assuming S distributed no cash to P in the liquidation. Therefore, S could dispose of all of its assets and liquidate with neither P nor S incurring any current tax liability.

To prevent this result, the 1986 technical corrections, §1804(e)(6), revise §332(b)(1) to provide that the corporation receiving the liquidating distribution must, on the date of the adoption of the plan of liquidation and at all times until receipt of the liquidating distribution, be the owner of stock in the liquidating subsidiary meeting the requirements of revised §1504(a)(2). The Senate Finance Committee Report [54] states that in applying §1504(a)(2) for this purpose, the objective is to harmonize §332 and §1504(a)(2). Thus, it is generally intended that other parts of §1504(a), such as §1504(a)(4), are applicable. But, according to the Finance Report, §1504(a)(5)(E) is not applicable because it is not concerned with §1504(a)(2) but rather with the effect of transfers within a group of a member's stock. The revised §332(b)(1) definition also applies even if one (or both) of the corporation's involved is not an includible corporation under §1504(b). For example,

[48] S. Rep. No. 665, 99th Cong., 2d Sess. 908-909 (1986)("Senate Report").
[49] *Id.* at 909.
[50] 1986 TRA, §1804(e)(3), amending P.L. 98-369, §60(b)(3).
[51] *Id.*, §1804(e)(4), adding paragraph (7) to P.L. 98-369, §60(b).
[52] Senate Report at 909.
[53] Senate Report at 910.
[54] *Id.*, at 911.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

under this rule, S in the Example above could be liquidated under §332, but S could avail itself of §337 only if P complied with §337(c)(3)(A)(i) (as in effect before the amendments made by 1986 TRA §631, discussed in Chapter 36, *supra*).

The 1986 technical corrections, §1804(e)(7), also revised the term "distributee corporation" under §337(c)(3). As amended, the term includes any corporation receiving a distribution in complete liquidation of the selling corporation to which §332 applies and includes each corporation upstream which receives a distribution complete liquidation of another distributee corporation to which §332 applies. For example, assume (i) M owns 100% of the stock of N, (ii) N owns 100% of the stock of O, and (iii) the three corporations file a consolidated return under §1504 (as amended by the 1984 TRA) for the calendar year 1985. If M transfers 30% of the stock of N to O, the three corporations would continue to be eligible, or be required, to file a consolidated return under §1504(a)(5)(E). If N adopted a plan of complete liquidation, sold all its assets, and liquidates within twelve months, under Regs. §1.1502-34, both M and O generally would be entitled to tax-free treatment under §332. However, N could not avail itself of §337 unless, among other things, both M and O complied with §337(c)(3)(A)(i). *See* Senate Report at 911.

Finally, the 1986 technical corrections, §1804(e)(8), conform the definition of "qualified stock purchase" in §338(d)(3) to the definition in §1504(a)(2).

C. *Effective Dates*

The 1986 TRA technical correction changes to the definition of excludable stock and the grandfather and sell-down rules, addition of the election to have the revised definition apply, and the exclusion of a DISC or any other corporation having accumulated DISC income are effective as if included in the 1984 Tax Reform Act. *See* 1986 TRA, §1881.

The revision to the §332(b)(1) definition generally applies with respect to plans of complete liquidation adopted after March 28, 1985. The revised definition also applies with respect to plans of complete liquidation adopted on or before March 28, 1985, pursuant to which any distribution is made in a taxable year beginning after 1984 (1983 in the case of an affiliated group that elects the revised, more stringent affiliated group definition) but only if the liquidating corporation and any corporation that receives a distribution in complete liquidation of such corporation are members of an affiliated group of corporations filing a consolidated return for the taxable year which includes the date of distribution.[55] The revised definition does not, however, apply if the liquidating corporation is a member of an affiliated group of corporations under §60(b)(2),(5),(6), or (8) of the Tax Reform Act of 1984, for all taxable years that include the date of any distribution pursuant to the plan of liquidation.[56] Thus, any affiliated group qualifying under the grandfather or other transition rules of the 1984 Act will continue to be subject to the former §332(b)(1) definition for purposes of a subsidiary liquidation.

The definition of a "distributee corporation" for purposes of §337(c)(3) is effective for plans of complete liquidation pursuant to which any distribution is made in a taxable year beginning after 1984 (after 1983 for an affiliated group to which an election to apply the revised §1504(a) affiliated group definition applies). 1986 TRA §1804(e)(7)(B).

Finally, the revised definition of a "qualified stock purchase" for §338 purposes applies in cases where the 12-month acquisition period (as defined in §338(a)(1) the Internal Revenue Code of 1954) begins after December 31, 1985.[57]

Note: The Senate Finance Committee Report sets forth six examples illustrating the application of the effective date rules for purposes of the revised §332 definition. The Report and the Examples are reproduced at page 610 of Volume I of this portfolio (pages 912 and 913 of the Senate Report.)

IV. Technical Corrections to the Corporate Reorganization Rules

A. *Overview*

Act §1804(g) makes two changes in the treatment of corporate reorganizations. Although these changes are denominated as technical corrections to the Tax Reform Act of 1984, Congress recognized that at least one of these changes has substantive implications by making its effective date prospective only.

B. *Treatment of Transferor Corporations*

Under prior law, several aspects of the treatment of target corporations in §368(a)(1)(C) and non-divisive §368(a)(1)(D) reorganizations upon their receipt and distribution of stock, securities, or boot were unclear or dependent upon whether such corporations distributed property to their shareholders. In the 1986 TRA, Congress attempted to introduce a somewhat more coherent system for the treatment of such corporations.

Section 1804(g) of the 1986 TRA amends Code §361 to provide in effect that target corporations in (C) and (D) reorganizations do not recognize gain or loss on their transfer to the acquiring corporation of property pursuant to the reorganization even to the extent that they receive — but do not distribute — boot received in exchange therefor. Instead, recognition generally is imposed, if at all, on the acquiring corporation on its transfer of boot or on the target corporation on its distribution to shareholders and creditors of retained assets. *See* Conference Report at II-843-44, Senate Report at 914.

Code §361 as amended makes clear that the liquidation rules do not apply to target corporations that liquidate pursuant to the plan of liquidation.[58] It thus reverses the premise behind *General Housewares Corp. v. United States*,[59] which applied former §337 to exempt gain on a target corporation's sale of stock received in a (C) reorganization as consideration for its assets. Such corporations will

[55] 1986 TRA, §1804(e)(6)(B).
[56] *Id.*
[57] 1986 TRA, §1804(e)(8)(B).
[58] Revised §361(b)(1).
[59] 615 F.2d 1056 (5th Cir. 1980).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

recognize gain [60] — but not loss — on the distribution to shareholders and creditors in the reorganization of property not transferred to the acquiring corporation and of boot received from the acquiring corporation but on which the latter avoided recognition.[61] Because §§336 and 337 do not apply, distributions of retained property and certain boot even to 80% corporate shareholders will trigger recognition of gain to the target corporation under revised §361(c). Target corporations in such reorganizations will take a carryover basis in such boot, increased or decreased by the amount of gain or loss recognized by acquiring corporations on their transfer of such boot.[62] However, since acquiring corporations will recognize gain or loss on the transfer of such boot, target corporations will in most cases not realize any gain or loss on the distribution of any boot received.[63]

In general, the provisions enacted pursuant to 1986 TRA §1804(g) treat transfers to creditors pursuant to (C) and (D) reorganization plans similar to distributions to shareholders.[64] Thus, transfers to creditors of stock or securities of the acquiring corporation (or its controlling parent corporation) received in such a reorganization do not cause the target corporation to recognize gain, except to the extent such transactions generate cancellation of indebtedness income.[65] However, transfers to creditors of retained property or certain boot would cause the target corporation to recognize gain under revised §361(c).

The above provisions are effective for transactions pursuant to plans of reorganization adopted after October 22, 1986. Act §1804(g)(4).

C. Drop-Down of Assets Acquired in Reorganizations

Under prior law, the Service took the position that a transaction is "described in" Code §368(a)(1)(D) — and thus under Code §368(a)(2)(A) cannot qualify as a reorganization under Code §368(a)(1)(C) — where substantially all of the assets of a corporation are transferred to a second corporation controlled by the acquired corporation or its shareholders, even though the transaction does not qualify as a (D) reorganization because it does fulfill the requirements contained outside §368(a)(1)(D) for tax free treatment.[66] Section 368(a)(2)(C) permits an acquiring corporation in a (C) reorganization — but not in a (D) reorganization — to transfer to a controlled subsidiary assets acquired from a target corporation without jeopardizing tax free treatment of the transaction.

In the 1984 Tax Reform Act, Congress expanded the definition of "control" for purposes of determining whether a transaction is "described in" §368(a)(1)(D), reducing the threshold for control to 50% and taking into account ownership by attribution. *See* former §368(c)(2). Thus, where a corporation transferred substantially all of its assets to a commonly controlled corporation solely for stock but that corporation dropped those assets down to a subsidiary, there was doubt whether the transaction would qualify under any tax free reorganization provision since the assets would ultimately be acquired by a corporation indirectly controlled by the transferor corporation and thus would be "described in" §368(a)(1)(D), but would not qualify for tax-free treatment as a (D) reorganization because of the asset drop-down.

Section 1804(h) of the 1986 TRA deletes paragraph (2) of §368(c) and adds subparagraph (H) to Code §368(a)(2) to provide that the attribution rules introduced in the 1984 Tax Reform Act are applicable only for determining whether a transaction "qualifies under" §368(a)(1)(D), and not whether a transaction "is described in" that section. The Act also specifies that the priority rule in §368(a)(2)(A) does not apply, for purposes of the drop-down rule in §368(a)(2)(C), to characterize as a (D) reorganization a transaction described in both §368(a)(1)(C) and §368(a)(1)(D). *See* Act §1804(h)(3). Thus, in a reorganization qualifying as a (C) reorganization without regard to §368(a)(2)(A), the acquiring corporation may drop down the assets of the target corporation to a controlled subsidiary without thereby jeopardizing tax free treatment.[67]

This provision is effective for transactions pursuant to reorganization plans adopted after July 18, 1984. *See* 1986 TRA, §1881, and 1984 TRA, §64(b).

V. Technical Corrections to the Collapsible Corporation Rules

A. Background

As in effect before the 1986 TRA effective dates, §341(a) provides that gain from (1) the sale or exchange of stock in a collapsible corporation and (2) certain distributions by a collapsible corporation is to be treated as ordinary income to the extent that such gain would otherwise be gain from the sale or exchange of a capital asset held for more than 6 months. Accordingly, to the extent that stock in a collapsible corporation is sold or redeemed less than 6 months after its acquisition by the shareholder (resulting in short-term capital gain), the collapsible corporation rules do not apply.

Ordinarily, the inapplicability of §341 to short-term capital gains is of no consequence, since such gain is taxable at ordinary income rates. If, however, the shareholder has a substantial short-term or long-term capital loss, of which only a limited amount may be set off against ordinary income,[68] the fact that §341 applies only to gain that would otherwise be long-term capital gain is potentially significant, since the losses might be used more quickly.

Also, since the §341 rules do not apply to short-term capital gain, the complete liquidation of a corporation under §333 may be carried out without fear of collapsibility where the shareholders hold the stock for less than 6 months before the liquidation. This approach might prove useful where the corporation is formed to hold property during construction and the shareholders wish eventually to

[60] *See* Senate Report at 914.
[61] Revised §361(c).
[62] Revised §361(b)(2).
[63] *See* Conference Report at II-844 (1986).
[64] Revised §361(b)(3) and flush paragraph under §368(b).
[65] *See* Conference Report at II-844 and n.1 (1986).
[66] Rev. Rul. 74-545, 1974-2 C.B. 122.
[67] *See* Senate Report at 914.
[68] §1221.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

operate the property in other than corporate from (without paying tax on appreciation in the property).

B. TRA Amendments

Act §1804(i) amends §341(a) so as to provide that the collapsible corporation rules shall apply whether or not the stock has been held for more than 6 months. Thus, what would have been short-term capital gain that could be "netted" against capital loss will be treated as ordinary income.

C. Effective Date

The §341(a) amendment is effective for sales, exchanges and distributions made after September 27, 1985.[69]

VI. Technical Corrections to Redemption Rules

A. Background

Section 304(a) provides that, in general, if each of two corporations are controlled by one or more shareholders, and in exchange for property one of the corporations (the "acquiring corporation") acquires stock in the other corporation (the "acquired corporation"), then the property is considered to have been distributed in redemption of the transferor's stock in the acquiring corporation. Whether the deemed redemption constitutes a dividend (§§302(d) and 301) or full payment in exchange for the transferor's stock (§302(a)) depends upon the extent of the reduction of the transferor's stock interest in the acquired corporation.[70] Before the 1986 TRA amendments, any transaction described in §304 was treated as a contribution by the transferor to the capital of the acquiring corporation.

If a §304 transaction constitutes a dividend to the transferor, the transferor's basis in the transferred stock is added to his basis in his stock in the acquiring corporation.[71] The acquiring corporation's basis in the transferred stock is equal to the transferor's basis in such stock.[72] If the transaction is treated as a distribution in full payment for the stock, the transferor's basis in his acquiring corporation stock remains unchanged.[73] The acquiring corporation's basis in the transferred stock is equal to the transferor's basis, increased by the amount of gain recognized by the transferor.[74]

Since, under pre-1986 TRA law, all §304 transactions are considered contributions to capital, and the basis to the acquiring corporation of the transferred stock is determined with reference to the transferor's basis, the acquiring corporation could not elect under §338 to treat an otherwise qualified acquisition as a deemed asset purchase. Section 338 requires that stock be acquired "by purchase," *i.e.*., that the acquired stock not have a carryover basis.[75]

B. 1986 TRA Amendment

Section 304(a), as amended by Act §1875(b), provides that the contribution to capital rule will not apply if the shareholder is treated as having exchanged its stock under §302(a). Thus, where §302(a) applies, the acquiring corporation is treated as having purchased the stock.

Therefore, under §304, as amended, an acquiring corporation may be eligible to elect §338 treatment of its acquisition of acquired stock.

> *Example*: A and B, who are unrelated, own 80% and 20%, respectively, of Corporation X stock. A, B, and C, all unrelated persons, each own 33⅓% of Corporation Y. A sells all of his Corporation X stock to Corporation Y for cash. Since A's interest in Corporation X is reduced from 80% to approximately 27%, the transaction qualifies as a disproportionate redemption under §302(b)(2). Thus, Corporation Y may elect to treat the acquisition as an asset acquisition under §338.

According to the legislative history, the amendment is not intended to alter pre-existing law treatment of the transferor-shareholder (including the transferor's basis in the stock of the acquiring corporation).[76]

C. Effective Date

The §304(a) amendment is effective with respect to stock acquired after June 18, 1984, in taxable years ending after such date.[77] It is not clear whether Treasury will provide a mechanism for a §338 election by an acquiring corporation that now qualifies for the election, but may not be able to make an election in timely fashion under §338(g)(1) (requiring election not later than the 15th day of the 9th month beginning after the month of the acquisition).

---

[69] Act §1804(i)(2).
[70] §304(b)(1).
[71] Regs. §1.304-2(a) and (c)(Ex. 1). Such basis may be reduced to the extent provided in §301(c)(2). *See* Regs. §1.304-2(a).
[72] *See* §362(a).
[73] Regs. §1.304-2(a) and (c)(Ex. 3).
[74] §362(a).
[75] *See* §338(h)(3)(A)(i).
[76] *See, e.g.*, S. Rept. No. 313, 99th Cong., 2d Sess. at 1047.
[77] Under certain circumstances, the taxpayer may elect to have the amendments apply to transfers occurring after August 31, 1982, in taxable years ending after that date. *See* P.L. 98-369 §712(1)(7)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 39

COOPERATIVE HOUSING

A. L. Suwalsky, Jr., Esq.
Silverstein and Mullens
Washington, D.C.

I. Background

Cooperative housing corporations are governed by a strict set of tax rules [1] which may compare unfavorably with the alternate form of co-ownership of dwelling units, the condominium. Although to the casual layman these forms of co-ownership may seem almost identical, there are very substantial legal and tax differences between cooperatives and condominiums. Both are creatures of modern property law, since they were conceived of during the major period of development of the common law.[2]

Cooperatives and condominiums are similar in that the "unit owner" is entitled to the exclusive use and occupancy of a designated apartment.[3] However, the condominium apartment owner possesses legal title to his dwelling in fee simple and may sell, pledge or encumber it. As such, he is entitled to deduct mortgage interest and property taxes and to treat it for tax purposes the same as the owner of a one-family dwelling. The common elements of the building in which the unit is located are co-owned by the owners of the individual units and maintained and managed by an association of unit owners. The land on which the building is situated may be owned by the co-owners or leased.

The cooperative apartment dweller, on the other hand, does not own his unit. The cooperative housing corporation of which the co-op member is a stockholder normally owns the apartment building and either owns or leases the real property upon which it stands. The individual occupying a dwelling unit owns only shares of stock in the cooperative corporation and is referred to formally as a "tenant-stockholder." Each unit in the cooperative has assigned to it a certain number of shares of stock of the cooperative which must be owned in order to gain occupancy rights to the apartment. When an individual acquires these earmarked shares of stock, he receives a "proprietary lease" to the apartment. If the tenant-stockholder seeks to acquire occupancy rights in a cooperative apartment on credit, he must pledge his cooperative stock and proprietary lease to the lender. Such stock is generally considered personal property so that the lender does not receive a security interest in real property as in the case of a mortgage. If the cooperative corporation owns the improvements or the underlying land, it is liable for property taxes and usually for a mortgage obligation. Because of these distinctions, the tenant-stockholder's right to income tax deductions for a portion of the coop's property taxes and interest payments is governed by special provisions of the Code and the right to such deductions is deemed a matter of "legislative grace."

As might be expected, since the government has created the right to tax deductions for tenant-stockholders, inevitably terms and conditions have been attached to obtaining such deductions — terms and conditions to which the condominium or ordinary homeowner is not subject, and violation of which can result in loss of deductions to an innocent tenant-stockholder. Because of the inequality of treatment between condominium and cooperative owners, there seems to be a slight trend toward liberalizing the tax code requirements for deductions.

In brief summary, Code §216 allows deductions for the tenant-stockholder's "proportionate share" [4] of real estate taxes and interest deductible by the cooperative corporation if the requirements of Code §216(b) are met.[5]

Code §216(b)(1) defines a housing cooperative as a corporation having only one class of stock outstanding and each shareholder of which is entitled solely by reason of ownership of stock to occupy a unit for dwelling purposes. Eighty percent of the gross income of the cooperative must be derived from tenant-stockholders (as rent, usually styled as a "monthly assessment" or "maintenance fee"). A number of other rules are also prescribed by Code §216.

II. Tax Reform Act Changes

Under Act §644(a), a person other than an individual (*e.g.*, a corporation, partnership or trust) is permitted to own a cooperative apartment notwithstanding the fact that such legal person may not occupy the unit without the permission of the coop corporation pursuant to post-TRA §216(b)(5). This can greatly ease the pressure on a coop with unsold apartments or apartments owned by a financial institution because of foreclosure. Pre-TRA Code subsections 216(b)(5) and (6) dealing with stock acquired through foreclosure by a lending institution and stock owned by persons from whom the corporation acquired its property have been discarded and replaced by the afore-

[1] I.R.C. 1954, §216.

[2] They are sometimes styled for purposes of statutory classification as "horizontal property regimes."

[3] Referred to hereafter for convenience as an "apartment" — the property could be a town house or even a detached house, however. Other forms of co-ownership, which include co-ownership of offices, house trailers, parking spaces and boat slips, are beyond the scope of this discussion.

[4] That portion of the interest and taxes of the coop determined by reference to the ratio of the number of shares owned to all outstanding shares, notwithstanding the value of the apartment held under the shareholder's proprietary lease.

[5] Additionally, Code §216(c) provides in certain cases that the shares of a tenant-stockholder may be treated as property subject to the allowance for depreciation under Code §167(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

mentioned rule regarding prior approval of occupancy by the cooperative corporation. In retrospect, there seems to have existed no logical reason to limit coop apartment ownership to individuals. This may once have stemmed from misguided idealism about home ownership.[6]

Post-TRA subsection 216(d) provides that no deduction is allowable to any stockholder for amounts paid to the coop which are chargeable to the coop's capital account. Any such amounts must be capitalized and added to the shareholder's stock basis. Thus, if an assessment or a portion of the monthly maintenance fee paid by a corporate shareholder is for capital improvements, the shareholder cannot deduct such amount.[7]

Another provision makes it clear that in the case of a unit used by the shareholder in his trade or business, depreciation is limited to the adjusted basis of the stock owned.[8]

A further change permits the coop to allocate to a shareholder an amount of interest and taxes proportionate to the value of his unit rather than basing the allocation solely upon the number of shares the stockholder owns.[9]

Uncodified technical changes are made by the Act relating to the refinancing of certain "Qualified Cooperative Housing Corporations." [10]

III. Effective Date

The changes to Code §216 outlined above are generally applicable to taxable years beginning after December 31, 1986.[11] For a full discussion of the tax treatment of these forms of property ownership, both before and after the effective date of TRA-1986, *see* 408 T.M., *Cooperative and Condominium Apartments.*

[6] Act §644(a) amending Code §216(b).
[7] Act §644(c) adding Code subsection 216(d).
[8] Act §644(b) amending Code §216(c).
[9] Act §644(d) amending Code §216(b)(3)(B).
[10] Act §644(e).
[11] Act §644(f).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 40

TAX TREATMENT OF REGULATED INVESTMENT COMPANIES

Andrew Huddleston, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

To be taxed as a regulated investment company (RIC), an entity must satisfy certain organizational, source of income, income distribution and asset diversification requirements, and must elect to be taxed as a RIC.[1] First, the entity must be a domestic corporation (or an association taxable as a corporation) that is registered under the Investment Company Act of 1940[2] as a management company or unit investment trust (or is exempt from registration as a common trust fund or similar fund).[3] Second, the entity must satisfy two income source requirements: (i) at least 90% of its annual gross income must be derived from dividends, interest, payments on certain securities loans, and gains from the sale or other disposition of stock or securities;[4] and (ii) less than 30% of its gross income may be derived from the sale or other disposition of stock or securities held for less than three months.[5] Third, the entity must distribute to shareholders each year at least 90% of the sum of its taxable income (without regard to capital gains) and its net tax-exempt income.[6] Fourth, the entity must satisfy asset diversification requirements, which limit the extent to which the assets of the RIC may include securities (other than government securities and securities of other RICs) either of any one issuer or any issuers a substantial portion of whose voting securities are owned by the RIC.[7]

Corporations that qualify as RICs are generally taxed under the rules applicable to regular subchapter C corporations. Unlike C corporations, however, RICs are allowed a deduction for dividends paid to shareholders, and thereby avoid the corporate-level tax on any income distributed to shareholders. In addition, any undistributed taxable income of a RIC (other than capital gains) is taxed at the highest corporate tax rate.[8]

Shareholders treat most distributions from a RIC as they would distributions from any other corporation. Thus, dividends received by individual shareholders generally are taxed as ordinary income to the extent of the RIC's earnings and profits. Special rules, however, provide that dividends paid out of net capital gains or, in the case of certain RICs, tax-exempt interest, are treated by the shareholders as long-term capital gains or tax-exempt interest, respectively.[9]

Many RICs are organized as "series" funds. A series fund is a single legal entity (either a corporation or a business trust) made up of several investment funds, each of which issues a separate class of stock of the entity. The owners of each separate class of stock have an interest only in the assets and income of the separate fund. Although the IRS has consistently treated a corporation organized as a series fund as a single corporation for tax purposes,[10] it has ruled privately that each series in a fund organized as a business trust would be taxed as a separate corporation.[11]

A RIC may adopt any fiscal year as its taxable year. It may treat certain dividends paid after the close of its taxable year as having been paid during the taxable year and deduct them during that year. Its shareholders are not required to include the dividends in income until the year in which they are actually paid.[12]

Before the Tax Reform Act of 1986, a taxpayer could buy stock in a RIC immediately before the ex-dividend date for payment of an exempt-interest dividend, hold the stock for 32 days after receiving the dividend, then sell it and recognize any loss on the sale.[13]

A personal holding company may qualify to be taxed as a RIC. However, if a RIC is also a personal holding company, any investment company taxable income which it earns will be taxed at the highest rate applicable to corporations.[14]

Under pre-1986 TRA law, RICs are not "third-party recordkeepers" for purposes of the notice requirements imposed by Code §7609 when the IRS issues summonses.

II. Overview—Statutory Changes

The Act makes 10 major changes in the tax treatment of regulated investment companies:

[1] Code §851-855.
[2] 15 U.S.C. 80.
[3] Code §851(a).
[4] Code §851(b)(2).
[5] Code § 851(b)(3).
[6] Code §852(a).
[7] Code §851(b)(4).
[8] Code §852.
[9] Code §852(b)(3)(B) and (5)(B).
[10] *See Union Trusteed Funds v. Comr.*, 8 T.C. 1133 (1947), acq., 1947-2 C.B. xx; Rev. Rul. 56-256, 1956-1 C.B. 316.
[11] PLRs 8508019, 8502022, 8444011, GCM 39211 (Apr. 13, 1984).
[12] Code §855(b).
[13] Pre-1986 TRA Code §852(b)(4).
[14] Pre-1986 TRA Code §852(b)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

First, §651(a) of the Act amends chapter 44 of the Code by adding new Code §4982 to provide a nondeductible excise tax of 4% on the excess of each calendar year's required distribution of income over the amount actually distributed to stockholders. The required distribution is 97% of the RIC's ordinary income for the calendar year plus 90% of its capital gain net income measured for the year ending on October 31 in the calendar year. The required and actual distributions for a calendar year will be adjusted to account for excesses or deficits in the previous calendar year's distributions. Actual distributions will also include amounts taxed in previous years although not actually distributed.

Second, §651(b) of the Act modifies Code §§852 and 855 to provide for constructive receipt by RIC shareholders of dividends declared in December and paid before February 1 of the following year. The overall effect of the excise tax and the constructive receipt provisions should be to compel RIC shareholders to recognize almost all RIC income in the same calendar year that it is deducted by a RIC.

Third, §654 of the Act modifies Code §851 to provide that, when a RIC is organized as a series fund, each fund will treated as a separate corporation for tax purposes.

Fourth, §653 of the Act modifies Code §851 to net the increases and decreases of qualified hedges so that the increases will not be included in RIC income; thus, they will no longer be counted in determining whether or not the RIC has exceeded its yearly limit on income from sales of stock held for less than three months.[15]

Fifth, §653(b) of the Act amends Code §851(b) to expand the definition of RIC income to include gains from sources related to its business of investing in stock or securities; these sources include (but are not limited to) gains from foreign currency dealings, options and futures contracts.

Sixth, §132(a) of the Act adds new Code §67(c) which will prohibit by regulations the deduction of certain operating expenses by conduit entities such as RICs, if the these same expenses would be subject to the new 2% floor on deductions if they are reported by individual taxpayers. Thus, if RIC expenses fall into the investment expenses category of §212, they must be reported in income ratably by RIC shareholders and they will be deductible by each shareholder only to the extent that they exceed 2% of adjusted gross income.

Seventh, §657 of the Act amends the requirement that RICs distribute all dividends pro rata to allow certain preferential dividends to large investors to reflect the lower costs of administration due to the size of their investments.

Eighth, §652 of the Act amends Code §851(a) to expand the definition of a RIC to include business development companies.

Ninth, §1804(c) of the Act denies any loss on the sale or exchange of RIC stock held by a taxpayer for six months or less to the extent that the taxpayer received exempt-interest dividends with respect to that stock.

Tenth, §1878(j) of the Act eliminates the requirement that a corporation maintain shareholder records to qualify as a RIC. Nonetheless, if records are not maintained, the RIC is taxed on any undistributed income.

The Act also extends the time allowed for certain notices to be sent to shareholders from 45 to 60 days and provides that RICs are treated as third-party recordkeepers under Code §7609 for purposes of IRS summonses.[16]

III. Detailed Analysis

A. The 4% Excise Tax

The Act amends the Code by adding a new excise tax on the excess of the required distribution by a RIC for each calendar year over the amount it actually distributes (the "distributed amount") during the year.[17] This tax must be paid by March 15 following the end of the calendar year. The required distribution is defined generally as 97% of the RIC's ordinary income received during the calendar year plus 90% of its capital gain net income for the one-year period ending on October 31 of the calendar year. This amount must be increased by the "grossed-up required distribution" for the preceding calendar year less the distributed amount for that year. The grossed-up required distribution for any year is defined as 100% of both ordinary income and capital gain net income (again, for the year ending on October 31) plus the same increase from the previous year for the excess of the RIC's grossed-up required distribution over its actual distribution. It is, in effect, the taxable income of the RIC for the previous year plus all amounts from earlier years which are not treated under this provision as having been distributed.[18]

The ordinary income of a RIC for purposes of Code §4982 is its investment company taxable income as defined in §852(b)(2) and calculated for the calendar year but without deducting for dividends paid or taking any gain or loss for the sale of any capital asset. Its capital gain net income is the same as that of §1222(9), the excess of gains from sales or exchanges of capital assets over the losses from such sales or exchanges, calculated for the year ending on October 31 of the calendar year. The distributed amount for any calendar year is the sum of the dividends paid, as defined in Code §561, during that calendar year plus any amounts on which the RIC has paid corporate income tax and the excess from any previous year of that year's distributed amount over the same year's required distribution. If a RIC pays a deficiency dividend, the dividend will be taken into account in the calendar year it is paid and the income giving rise to it will also be treated as arising during that year. Thus, unlike the treatment of a deficiency dividend in Code §860, the payment of a dividend to satisfy a RIC's income distribution requirements will not cause retroactive readjustment which might subject the RIC to the 4% excise tax. The distributed amount will not, however, be increased by any dividends distributed

[15] H.R. Rep. No. 841 ("Conference Report"), 99th Cong., 2d Sess. II-245 (1986).

[16] Act §§655 and 656.

[17] Act §651(a), adding §4982 to the Code.

[18] Conference Report at II-244.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

after the calendar year (covered by Code §855) or by any exempt interest dividend as defined in Code §852(b)(5).

It would be possible for a RIC to fail to meet the requirements for avoiding the excise tax when losses incurred after October 31 but before the close of the RIC's taxable year would prevent it from having sufficient earnings and profits for its distributions to be treated as dividends. To prevent this, the Act provides that a RIC is considered to have sufficient earnings and profits to treat any distribution as a dividend when it is designated as such by the RIC. This does not, however, cover any distribution which would be treated as a redemption under Code §302(a) and will apply only to the extent that the distributions during any calendar year do not exceed the RIC's required distribution for the calendar year.[19]

The Act also provides that capital losses incurred after October 31 of any taxable year are not included in calculating net capital gain for purposes of determining the amount of capital gain dividends which a RIC may distribute during the year.[20] Any capital losses incurred after October 31 are treated as arising after the first day of the next taxable year. The Treasury is authorized to issue regulations which will apply the same rule for determining a RIC's taxable income. The Conference Report states that these regulations should be drafted to prevent use of this rule for tax avoidance, such as paying return of capital dividends in a succeeding year or offsetting the taxes that would be incurred on capital gains recognized in the following year.[21]

There is one exception to the period specified for computing a RIC's capital gain. A RIC which uses a taxable year ending on either November 30 or December 31 may make an election to use its actual taxable year, rather than the year ending on October 31, to calculate its capital gain net income for purposes of the excise tax distribution requirement. The election is irrevocable.[22]

This change in the tax treatment of RICs was intended to eliminate a method of tax deferral available to RIC shareholders under previous law.[23] When a RIC used a taxable year other than the calendar year or distributed dividends after the close of its taxable year but elected to have these dividends treated as paid in the previous year (under Code §855), its shareholders might defer recognition of significant amounts of income until the following taxable year. A RIC with a taxable year ending on January 31 might distribute dividends to calendar year shareholders during January; the shareholders would not have to report the income until after the end of the following December. Similarly, a RIC with a calendar taxable year might elect to have dividends paid in January treated as having been paid before the end of the previous December; its shareholders recognized this income in the later year although the RIC deducted it in the earlier year.

The original House bill contained no provision concerning the treatment of RICs. The Senate, however, proposed to require all RICs to use the calendar year for tax purposes as well as providing a 5% excise tax on any dividends distributed under the provisions of Code §855.[24] The Conference, in response to criticism of the effects of this change, chose instead a more complicated pattern to ensure that RICs' income would be distributed currently without denying them flexibility in the choice of a taxable year.[25]

The amendments creating the 4% excise tax apply to calendar years beginning after December 31, 1986.[26]

B. Constructive Inclusion of Dividends

The Act also amends Code §§852 and 855 to provide that any dividend declared by a RIC in December of any calendar year and payable to shareholders as of a specified date in that month are deemed paid by the RIC and received by each shareholder on the record date, unless the dividend is actually paid on or after February 1 of the following year.[27] This provision does not apply for purposes of §855(a), thereby allowing a RIC that has a taxable year other than the calendar year to treat the dividend as paid prior to December. This amendment applies to calendar years beginning after December 31, 1986.[28]

C. Tax Treatment of Series Funds

Many RICs, referred to as series funds, are made up of several investment funds, each of which is beneficially owned by a separate class of shareholders. Under previous law, if a RIC was organized as a corporation, it was treated as a single corporation, even if it consisted of several funds. By contrast, there was uncertainty whether a series RIC organized as a business trust should be treated as a single corporation or as multiple corporations.[29]

The Act amends Code §851 to provide that each separate series of a series fund RIC will be treated for tax purposes as a separate corporation.[30] A fund is defined as a segregated portfolio of assets, the beneficial interests in which are owned by the holders of a class or series of the RIC's stock that is preferred over all other classes or series in respect of this portfolio of assets. Under this provision the qualification tests and other rules for RIC status will be applied on a fund-by-fund basis. For example, each fund would have to meet the diversification requirement to qualify for RIC status, and each fund also would calculate separately the amount of capital gains dividends that it may pay as well as the amount of tax exempt interest dividends that it may pay. Capital losses of one series would no longer offset capital gains from another series, thereby eliminating a shift of tax benefits among the shareholders of different series.

The Act also provides that, if a series fund has been treated as a single corporation up to the effective date of this revision, neither the corporation, its funds nor its

[19] Act §651(b), amending Code §852(c).
[20] Act §651(b), amending Code §852(b)(3)(C).
[21] Conference Report at II-245, n. 31.
[22] Act §651(a); Code §4982(e)(4).
[23] S. Rep. No. 313 ("Senate Report"), 99th Cong., 2d Sess. 261 (1986).
[24] Section 633 of the Senate-passed version of H.R. 3838.
[25] Conference Report at II-243.
[26] Act §651(d).
[27] Act §651(b), adding Code §852(b)(6) and amending §855(b).
[28] Act §651(d).
[29] Conference Report at II-242.
[30] Act §654(a), adding subsection (q) (which should be (h)) to Code §851.

shareholders will realize or recognize income or loss as result of treating the funds as separate corporations.[31] Further, the Act provides that the tax attributes of such a RIC will be "appropriately" allocated among its funds.[32] Presumably, the IRS will draft regulations to clarify the tax consequences of this "deemed reorganization," although the statute does not specifically authorize their issuance.

For series funds which have been treated as a single corporation, the amendment will apply to taxable years beginning after October 22, 1986.[33]

D. Hedging Gains

The Act amends Code §851 (which defines a regulated investment company) to net any increases and decreases in the value of qualified hedge positions so that these transactions will be excluded in determining whether or not a RIC has met the requirement that not more than 30% of its income be derived from sales of stock held for less than three months.[34] This requirement has frequently been criticized for being an unnecessary guard against a RIC's functioning as a securities broker in view of the conditions imposed by the Investment Company Act of 1940 and, thereby, for imposing unnecessary complexity on the management of a RIC. A separate proposal before Congress would have eliminated the requirement altogether [35] but the Senate Finance Committee chose only to alleviate the problem by removing one of the principal pitfalls involved. Under previous law, the increase registered by one half of a hedge position would be included in income without being offset by the corresponding decrease, thereby, in many cases, swelling the amount of income earned on stock held for less than three months. Under the new provision, for purposes of applying this test, any increase in value on a position that is part of a designated hedge is offset by any decrease in value (whether or not realized) on any other position that is part of the same hedge. Increases and decreases in value are taken into account only to the extent attributable to increases or decreases in value during the period of the hedge. The rule applies both for calculating gains from the sale or other disposition of stock or securities held for less than three months and also for the gross income of a RIC under §851(b)(3).

A designated hedge is defined as any transaction where the RIC's risk of loss with respect to an investment in any property is reduced by (i) the RIC's having an option to sell, being under a contractual obligation to sell (*i.e.*, a put option), or having made (and not closed) a short sale of substantially identical property; (ii) the RIC's being the grantor of an option to buy (*i.e.*, a call option) substantially identical property; or (iii) under regulations authorized by the Act, the RIC's holding of one or more other positions. The positions that are part of the hedge must be clearly identified by the RIC in the manner prescribed by regulations.[36] A designated hedge may include a qualified covered call (as defined by §1092(c)).[37]

The Conference Report outlines the means for identifying a designated hedge until the regulations are issued.[38] The hedge may be identified by either of two means:

(i) The positions that are part of the hedge may be placed in a separate account that is maintained by a broker, futures commission merchant, custodian or similar person. The account must be designated as a hedging account and the person in charge of the account must make notations identifying the hedged and hedging positions and the date on which the hedge is established.

(ii) A broker, merchant, custodian or similar person may designate the positions as a hedge for purposes of these provisions, provided that the RIC is provided with a written confirmation stating the date the hedge is established and identifying the hedged and hedging positions.

These amendments apply to taxable years beginning after October 22, 1986.[39]

E. Expansion of RIC Income Definition

The Act liberalizes the types of income which may be included in determining whether a RIC has satisfied the requirement that it derive 90% of its income from permitted sources. In particular, the Act treats the following as permitted income: [40] (i) gains from options and futures contracts that are related to a RIC's portfolio assets; and (ii) gains from foreign currency transactions related to a RIC's investment activities. The Treasury is, however, given the authority to exclude foreign currency gains which are not ancillary to the RIC's principal business of investing in stock or securities, or the options and futures contracts which relate to them.[41] The Act also provides that the term "securities" as used for purposes of determining whether a corporation satisfies the income source rules has the same meaning as under §2(a)(36) of the Investment Company Act of 1940.[42]

These amendments apply to taxable years beginning after October 22, 1986.[43]

F. Treatment of RIC Operating Expenses

Section 132 of the Act adds Code §67 to limit the deduction of numerous expenses related to the production of income to their excess above 2% of an individual taxpayer's adjusted gross income. To prevent circumvention of this rule, the Act denies deduction of such expenses by conduit entities, including RICs. The Treasury is authorized to draft regulations which will specify the manner in which these expenses will be allocated to the individuals who are taxed on the income of the conduits.[44] Apparently, under

---

[31] Act §654(b)(2).
[32] Act §654(b)(2)(B).
[33] Act §654(b)(1).
[34] Act §653(a), adding subsection (g) to Code §851.
[35] H.R. 3397, 99th Cong., 2d Sess. (1986).
[36] Act §653(a), adding subsection (g) to Code §851.
[37] Conference Report at II-246.
[38] *Id.*
[39] Act §653(d).
[40] Act §653(b), amending Code §851(b)(2).
[41] Act §653(c).
[42] Act §653(b).
[43] Act §653(d).
[44] Act §132(a), adding Code §67(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the new rule, the individuals, rather than the conduit, will deduct their shares of investment operating expenses and these deductions will be limited by the 2% of AGI floor. Neither the Act nor the Conference Report specifies that individual shareholders will add their shares of deductions into income, but the Report provision that the Treasury regulations should deal with reporting requirements to effectuate the statute strongly suggests that this is the procedure intended.[45]

These amendments apply to taxable years beginning after December 31, 1986.[46]

G. *Preferential Dividends*

Section 657 of the Act amends Code §562(c) (which requires a RIC to distribute dividends pro rata) to allow a RIC to pay different dividend rates where the difference reflects savings in administrative costs (but not differences in management fees). These dividends, however, may be paid only to shareholders who have made initial investments of at least $10 million.

This amendment applies to distributions made after October 22, 1986.[47]

H. *Business Development Companies*

As revised by the 1986 Act, Code §851(a) allows a business development company registered under the Investment Company Act of 1940 to qualify as a RIC. The same change is made in Code §851(a), which allows RICs to use stock of subsidiaries which furnish capital to development companies to satisfy certain stockholding requirements for RIC status.

Under previous law, a RIC had to be registered with the Securities and Exchange Commission at all times during its taxable year as either a management company or a unit investment trust under the Investment Company Act of 1940, or had to be a common trust fund or similar fund that is not included in the term "common trust fund" under the Internal Revenue Code and that is excluded by the Investment Company Act from the definition of investment company. To register under the Investment Company Act of 1940 a corporation must have at least 100 stockholders or must be making proposing to make a public offering.

The Small Business Incentive Act of 1980 allowed certain investment companies which provide capital and managerial assistance to small businesses to elect to be treated as "business development companies" instead of registering under the Investment Company Act. However, a small business investment company could qualify to be treated as a RIC only if it met the requirements of the Code, including registration under the Investment Company Act.

The 1986 Act allows any company registered under the Small Business Company Act, so long as it meets the other stockholding, asset, and distribution requirements in the Code. The Act does not impose any definition for a business development company beyond its being registered under the Small Business Incentive Act. An additional requirement to prevent a business development company's also being a personal holding company was included when the change was first proposed but was eliminated after other changes in the definition of a RIC made this qualification unnecessary.

This change is effective for taxable years beginning after December 31, 1986.

I. *The Disallowance of Losses on Certain Stock Sales*

Before the Tax Reform Act of 1984 (P.L. 98-369), it was possible for a taxpayer to convert short-term capital gain to long-term capital gain by buying stock of a regulated investment company immediately before the ex-dividend date of a long-term capital gain distribution and then selling the stock 32 days after receiving the distribution of the dividend. Although Congress made this conversion far more difficult in the 1984 TRA,[48] it did include a similar provision to prevent a similar benefit from the short-term ownership of stock on which a tax-exempt interest dividend is paid. Under pre-1986 TRA law, a taxpayer could buy RIC stock immediately before the ex-dividend date of an exempt-interest dividend, sell the stock 32 days after receiving the dividend and recognize any loss on the sale.[49]

The 1986 Act amends Code §852(b)(4) to disallow any loss on the sale or exchange of RIC stock, to the extent that the taxpayer has received exempt-interest dividends with respect to that stock, if the taxpayer has held the stock for six months or less.[50] The Act does contain an exception for sales or exchanges made pursuant to a periodic liquidation plan under Code §852(b)(4)(D).[51] Also, the Act gives the Secretary authority to shorten the 6-month requirement to a period which is not less than (i) 31 days nor (ii) the period between the regular dividend distributions in which the RIC distributes at least 90% of its net tax-exempt income.[52] The Secretary should shorten this distribution period only where the purpose of the holding-period requirement can be achieved without requiring that stock be held for six months. A RIC which regularly distributes between 90% and 110% of its net tax-exempt income earned between dividend payments will satisfy the purpose of the holding period requirement.[53] The holding period for purposes of this requirement will be measured by the rules of Code §246(c)(3) and (4) with the term of six months substituted for the number of days specified in Code §246(c)(3)(B).[54] This amendment applies to RIC stockholdings which begin after March 28, 1985.[55]

J. *Stock Ownership Records*

Under pre-1986 TRA law, all RICs were required to maintain records of stock ownership in compliance with regulations prescribed by the Treasury.[56] The Tax Reform Act of 1984 [57] modified previous law by allowing a personal

[45] Conference Report at II-34.
[46] Act §151(a).
[47] Act §657(b).
[48] *See* §55 of the Tax Reform Act of 1984, P.L. 98-369.
[49] Pre-1986 TRA Code §852(b)(4).
[50] Act §1804(c).
[51] Act §1804(c)(3).
[52] Act §1804(c)(4), adding subparagraph (E) to Code §852(b)(4).
[53] Senate Report at 907.
[54] Act §1804(c)(2), amending Code §852(b)(4).
[55] Act §1804(c)(6).
[56] Pre-1986 TRA Code §852(a)(2).
[57] P.L. 98-369.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

holding company to be treated as a RIC. The 1984 TRA provided, however, that any investment company taxable income of a RIC which is also a personal holding company would be taxed at the highest rate for corporations.[58] This change eliminated the necessity for a RIC to keep shareholder records which were intended to assure that it was not a personal holding company and thus maintain its RIC status. Therefore, the 1986 Act deletes from the Code the requirement that a corporation maintain shareholder records to qualify as a RIC.[59] However, the 1986 Act also provides that if a RIC does not maintain these records, its investment company taxable income will nonetheless be taxed at the highest corporate rate, since this is the treatment provided for personal holding companies.[60] Thus, unless a RIC is also a personal holding company, it will nonetheless need to maintain shareholder records to continue to have its investment company taxable income taxed at lower rates. If a RIC retains little income, however, the cost of omitting this recordkeeping may be relatively slight.

This amendment applies to calendar years beginning after December 31, 1982.[61]

[58] §1071 of the Tax Reform Act of 1984, P.L. 98-369.
[59] Act §1878(j)(1), amending Code §852(a).
[60] Act §1878(j)(2), amending Code §852(b)(1).
[61] §1071(a)(3) of the Tax Reform Act of 1984, P.L. 98-369.

K. Notice and Third-Party Recordkeeper Changes

Before the 1986 TRA, the Code required a RIC to send various notices to its shareholders within 45 days after the end of its taxable year.[62] These notices are customarily included as part of the RIC's annual report. The Securities and Exchange Commission has recently extended the time for mailing annual reports to shareholders from 45 days to 60 days after the end of the RIC's taxable year. Consequently, the Act has extended notice requirements to avoid the waste of repetitive mailings by RICs to their shareholders.[63] The lengthened period applies to notice for (i) capital gain dividends, (ii) exempt-interest dividends, (iii) income derived from taxes paid on that income to foreign countries, (iv) dividends deductible under Code §243,[64] and (v) spillover dividends under Code §855. This change is effective for taxable years beginning after October 22, 1986.[65]

Code §7609 contains certain procedural rules applicable to summons served by the IRS on "third-party recordkeepers." This term is defined to include various types of financial institutions such as banks, savings companies and brokers. The Act extends the protection of these rules to RICs and their agents, effective for summonses served after October 22, 1986.[66]

[62] Code §§852(b)(3)(C), 852(b)(5)(A), 853(c), 854(b)(3) and 855(c).
[63] Act §655.
[64] Code §854(b)(2), as amended by Act §655.
[65] Act §656(b).
[66] Act §656, adding subparagraph (H) to Code §7609(a)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 41

REAL ESTATE INVESTMENT TRUSTS

A. L. Suwalsky, Jr., Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. Background

A Real Estate Investment Trust ("REIT") is a legal entity organized in corporate, trust or association form which provides a vehicle for pooling the funds of a substantial number of investors to invest in real estate projects. If the requirements of Internal Revenue Code §§856 through 859 are complied with, the REIT functions as a pass-through entity or conduit, and profits from the real estate investment are taxed only on the investor level. There are two major categories of REITs, the equity REIT which owns property and generates most of its income through rents, and the mortgage REIT which invests primarily in mortgages and receives most of its income from interest and fees. By far, the most common type of REIT is the equity REIT. REITs can be further categorized by the type of properties in which they invest and the manner in which they choose to conduct operations.

As might be expected, there is a price to be paid in terms of rules and restrictions for a REIT's tax-favored status as a pass-through entity. These rules are complex and contain pitfalls and penalties justified by the fact that substantial tax revenues are being foregone. Although the first bill authorizing REITs passed the Congress in 1956,[1] the Treasury opposed the bill and President Eisenhower vetoed it. After the Treasury withdrew its objections in 1960, the legislation was enacted.[2] The original Code provisions dealing with REITs were quite restrictive and imposed the draconian penalty of (inevitably retroactive) disqualification and taxation of all income at corporate rates even if the income had already been distributed to shareholders/certificate holders.[3] As a result of actual operating experience, particularly in economic turndowns, major modifications were made in the provisions in the late 1970s and alternatives to absolute disqualification were provided.[4]

Notwithstanding the liberalization of the 1970s, the tax rules with respect to REITs remained restrictive and complex, arising, in part, from a fear on the part of some in the real estate industry that REITs possessed an unfair advantage vis-a-vis fully taxable real estate corporations. An example of these restrictions is the "independent contractor requirement" of §856(d) which requires that an independent contractor from whom the trust itself does not derive or receive any income be used to operate the properties owned by the REIT and to provide services to tenants. Other significant restrictions cover property which has been foreclosed upon, the minimum holding period for REIT property and annual limitations on sales of property owned by a REIT.[5]

The basic rules for the tax treatment of REITs immediately before TRA-1986 are summarized as follows. The general requirements for qualification as a REIT are set out in §856(a). It must have centralized management by trustees or directors whose actions are not subject to ratification by shareholders. Ownership must be evidenced by transferable shares or certificates. The REIT must be otherwise taxable as a domestic corporation but it cannot be a financial institution or an insurance company. Ownership of interests in a REIT must be held by at least 100 persons; five or fewer individuals cannot own, directly or indirectly, 50% or more in value of the outstanding interests in the REIT, *i.e.*, if all the REIT's income were considered personal holding company income, the REIT would not be a personal holding company. Section 856(b) provides that the conditions described in §856(a)(1)-(4) must be met during the entire taxable year; the condition in §856(a)(5) must exist at least 335 days of a taxable year or during a proportionate part of a taxable year of less than 12 months.

Further limitations on REIT status are contained in §856(c) which promulgates the "75 percent test," the "95 percent test" and the "30 percent test" relating to sources of income. At least 75% of a REIT's gross income during a taxable year must be derived from (1) rents from real property; (2) interest on obligations secured by mortgages

[1] H.R. 4392, 84th Cong., 2d Sess. (1956).
[2] P.L. 86-779, 86th Cong., 2d Sess. *See* H.R. Rep. No. 2020, 86th Cong., 2d Sess. (1960), 1960-2 C.B. 819.
[3] Holders of certificates of beneficial interest in a realty trust. Hereinafter both certificate holders and shareholders are referred to as "shareholders."
[4] Tax Reform Act of 1976, P.L. 94-455, 94th Cong., 2d Sess. (1976).
[5] The fear of domination of commercial real property ownership by REITs seems analogous to the wide-spread 19th century prohibition against ownership of real property by corporations which, of course, proved to be based on groundless apprehensions. The original business trusts set up to own real estate were established to get around such restrictions on corporate ownership of both real estate and securities and also to avoid a second level of taxation on income from such investments. This advantageous tax treatment ended in 1935 when the Supreme Court held in *Morrissey v. Comr.*, 296 U.S. 344, that business trusts were subject to corporate taxation.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

or interests in real property; (3) gain from the sale of property which is not held for sale in the ordinary course of business, income and gain from interests in other REITs; and (4) refunds and abatements of real property taxes, income and gain from foreclosure property, fee income arising from real property and gain from the sale of real estate assets. §856(c)(3). The 95% test requires that 95% of a REIT's gross income in a taxable year be derived from sources satisfying the 75% test plus other interest, dividends (without regard to the dividends received exclusion), and gain from the sale or other disposition of stock and securities. §856(c)(2). Additional complex rules apply to income or gains from foreclosure property for purposes of the 75 and 95% tests.[6]

The 30% test relating to REIT income prescribes that less than 30% of gross income must be derived from the sale or the disposition of stock or securities held for less than six months, property disposed in a prohibitive transaction and real property and interest in mortgages on real property held for less than 4 years. §856(c)(4).

A REIT is also strictly limited in the assets it may own. At the close of each quarter of the taxable year at least 75% of the value of its assets must be represented by real estate assets (including interest in mortgages on real property) cash and receivables and government securities; and no more than 25% of its total assets may be represented by securities (other than real estate securities). A REIT may not hold more than 10% of the outstanding voting securities of any issuer or invest more than 5% of the value of the total assets of the REIT in the securities of any one issuer. §856(c)(5). There are numerous elaborations and some exceptions to the foregoing rules.[7]

To ensure that the maximum amount of REIT income is taxed to the shareholders, §857(a) requires that a REIT distribute at least 95% of its earnings (excluding net capital gains) as taxable dividends. Certain adjustments are provided for. Further, the REIT must distribute at least 75% of its income before the end of the taxable year or face a 3% excise tax penalty on the underdistribution.[8]

The ordinary corporate tax levied by §11 is applied to undistributed earnings of a REIT. §857(b)(1). Separate taxes are imposed on income from foreclosure property (at the highest corporate rate)[9] on prohibitive transactions (at a 100% rate),[10] and on failure to meet either the 75% test or 95% income test while the REIT still maintains qualification as such under §856(c)(7) (at a 100% rate on the larger of the net amounts by which the REIT fails to make either the 95% or 75% test).[11]

For a full discussion of the provisions relating to the taxation of REITs, *see* 107 T.M., *Real Estate Investment Trusts*.

B. Overview

REITs lost a great deal of their appeal as investment vehicles in the mid-1970's when a change in economic conditions caused a significant number of poorly managed and over-optimistic REITs to fail or suffer severe setbacks. The changes in the taxation of income and losses from real estate investments made by The Tax Reform Act of 1986 [12] have engendered some comment in the financial community that REITs may now be favorably reconsidered as an investment vehicle by sophisticated investors. This predicted change in attitude comes about from a combination of provisions which ease the restrictions on REITs and impose new strictures on other forms of real estate investments, *e.g.*, the passive loss limitations, less favorable depreciation rules, elimination of the capital gains differential and imposition of an "almost escape-proof" minimum tax. The effect of the passive loss limitations and other changes made to the heretofore highly tax-favored status of real estate investments, when combined with lower marginal tax rates under the Act, has been to greatly increase investor interest in income-producing investments such as REITs.[13]

On balance, the changes made by TRA-1986 may be seen as favorable to REITs. Although more of a REIT's taxable income is required to be distributed before the end of each year and the nondeductible excise tax on failure to make required distributions is increased by one-third, a number of restrictions on operation were eased. The basic requirements for qualification as a REIT, however, remain in place. The Senate Report [14] notes that the modifications brought about by the bill are intended to allow REITs to act in accordance with existing market conditions and to retain the primarily passive nature of these real estate investments.[15]

II. The Tax Reform Act of 1986

A. Changes to Basic Requirements [16]

1. Calendar Year Accounting/Distributions

REITs formed after October 4, 1976 have always been required to be calendar year taxpayers.[17] The Act puts substantial pressure on fiscal year REITs to change to the calendar year by causing the fiscal year reporting entities to keep a second set of books on the calendar year basis and to make payouts to shareholders on a calendar basis. Among the amendments made to §4981 by the Act was the changing of "taxable year" to "calendar year" throughout the provision.[18]

2. Initial Change in Accounting Period

The 1986 TRA permits entities that have not commenced in an active trade or business to change their accounting year to the calendar year without obtaining the Commissioner's consent in conjunction with the making of an initial REIT election. This provision was designed to apply to new entities which were formed for the purpose of

[6] §856(e).
[7] §856(c).
[8] §4981.
[9] §857(b)(4).
[10] §857(b)(6).
[11] §857(b)(5).
[12] P.L. 99-514, 99th Cong., 2d Sess. (1986).
[13] Note at the outset, however, that REIT income is portfolio income, not passive income, and thus cannot be used to offset passive losses. *See* Senate Report No. 313, 99th Cong., 2d Sess. (May 29, 1986) p.728 ("Sen. Rep.").
[14] Sen. Rep. at pp. 769-81.
[15] Sen. Rep. at 774.
[16] Act §661.
[17] §859.
[18] Act §668(a) and (b) amending §4981.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

becoming a REIT and which wish to adopt a calendar year after an initial period in which the proceeds of a stock offering were received. Granting permission to elect without consent should ease the newly-formed REIT's burden.[19]

3. Other Requirements

Notwithstanding the §856(a)(5) and (6) tests, if an entity otherwise meets applicable qualification requirements it may elect REIT status even though five or fewer persons own more than 50% of its stock or if it has fewer than 100 shareholders or holders of beneficial interests, providing that it was not a REIT in any prior year. The waiver is applicable to the first year following election. Act §661, amending §856 by adding subsection (h). If a corporation has never qualified as a REIT and has accumulated earnings and profits, eligibility to elect REIT status is dependent upon prior distribution of the accumulated E&P.

B. Penalty for Failure to Distribute

1. Generally

The penalty provisions of Code §4981 with respect to failure to make required distributions of income before the end of the taxable year were considerably stiffened by increasing the base to which the nondeductible excise tax is applied (introducing the term "required distribution"), by raising the rate from 3% to 4%, and by changing taxable year to calendar year. Act §668(a). Also, amended §4981(b)(1) provides that, in order to avoid the imposition of the excise tax, the "required distribution" to be made by the last day of each calendar year is 85% of the REIT's ordinary income for the calendar year plus 95% of the REIT's capital gain net income (as per §1222(9)) for the calendar year, plus any prior year's shortfall.[20]

2. Deemed Distributions

New Code §857(b)(8) provides that, with respect to any dividends declared by a REIT in December of any calendar year and payable to stockholders of record as of a specified date in December, such dividend will be deemed to have been paid by the REIT and received by the stockholder on the record date. This provision will apply only if such dividend is actually paid before February 1 of the following calendar year.[21] Note, however, that this provision does not apply for purposes of §858(a). *See* H.R. Rep. No. 841, 99th Cong. 2d Sess. at II-218 (1986) ("Conf. Rep.").

3. Section 6697 Penalty

Act §667 amends Code §6697 to provide for the elimination of the §6697 penalty tax relating to deficiency dividends (§860(f)). The Senate Report [22] indicates that this action was taken because the imposition of interest and penalties based upon the full amount of the deficiency is deemed adequate compensation to the Treasury for the deferred tax liability resulting when the REIT distributes less than the required distribution for a taxable year.[23]

4. Sufficient Earnings and Profits

The 1986 TRA also provides that a REIT will be deemed to have sufficient earnings and profits to treat as a dividend any distribution during any calendar year (other than a redemption) that is treated as a dividend by the REIT, but only to the extent that the amount distributed for such calendar year does not exceed the required distribution for that year. This is a coordinate provision to the changes in §4981 placing the excise tax computation on a calendar year basis and is applicable to fiscal year REITs.[24]

C. Asset and Income Requirements [25]

1. Use of Subsidiaries

For the first time, REITs would be permitted to hold assets through subsidiaries.[26] All assets, liabilities and items of income, deduction or credit of a "qualified REIT subsidiary" are to be treated as assets, etc. of the REIT. §856(i)(1)(B). A qualified REIT subsidiary is defined as a corporation 100% of whose stock was owned by the REIT at all times when the subsidiary was in existence. The Conference Report makes it clear that a corporation whose stock was acquired in conjunction with a §338 election is included.[27] Adding to the importance of this change is the fact that the "75% of income" test, [28] is permitted to be applied on an entity-wide basis, thereby allowing the REIT more flexibility than if it only held the assets on a single level.

2. New Capital

REITs are provided additional flexibility with the concept of "qualified temporary investment income." Act §662(b). Under this concept, if a REIT receives new equity capital and temporarily invests the proceeds in stock or debt instruments, then for a 1-year period beginning on the date the capital is received, income from these investments is treated as qualifying income for the 75% income test.

Qualified temporary investment income is defined as any income which (i) is attributable to stock or debt instrument, (ii) is attributable to the temporary investment of "new capital," and (iii) is received or accrued during the 1-year period beginning on the date which the REIT receives such capital. Act §662(b)(3) adding new subsection 856(c)(6)(D)(i).

Section 856(c)(6)(D)(ii) defines new capital as any amount received by the REIT (1) in exchange for stock in such trust (other than pursuant to a dividend reinvestment plan) or (2) in a public offering of debt obligations of such trust which have maturities of at least five years.

Also, for one year following the receipt of new equity capital, the income received from investment of the proceeds is deemed to be income from real estate assets and thus satisfies the 75% test of §856(c).

[19] Act §661(c) adding new subsection 859(b).
[20] Act §668(a) amending §4981.
[21] Act §668(b) amending §857(b).
[22] Sen. Rep. at 777.
[23] Act §667 amending §6697.
[24] Act §668(b)(2) amending §887(d).
[25] Act §662.
[26] Act §662(a) adding subsection 856(i).
[27] Conf. Rep.at II-221.
[28] §856(c)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

D. Definition of Rents and Interest

1. Shared Appreciation Mortgages

Act §662(c) amends Code §856 by adding new subsection 856(j). Section 856(j)(1) provides that for purposes of §§856(c) and 857(b)(6), any income derived from a "shared appreciation provision" will be treated as gain recognized on the sale of secured property. Section 856(j)(4) defines "shared appreciation provision" as any provision which is in connection with an obligation which is held by the REIT and is secured by an interest in real property, and which entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain which would be realized if the property were sold on a specified date).

Expenditures made with respect to the property by any holder are deemed to be made by the REIT (for purposes of §857(b)(6)(C)(ii)). §856(j)(2)(B). The REIT is treated as holding the secured property for the period during which it it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as property described in §1221(1) if it is such property in the hands of the person holding the secured property (or if it would be such property if held by the REIT). The Conference Report states that the REIT's holding period of the obligation to which the shared appreciation provision relates (and not the obligor's holding period of the secured property if longer than the REIT's holding period) must be at least four years for the safe harbor of §857(b)(6)(C) to apply.[29]

Any gain achieved is treated as a gain on the sale or exchange of the underlying property and thus qualifies as 95% income under §856(c)(2)(D) unless the obligor on the obligation to which the shared appreciation provision relates is holding the property for sale to customers in the ordinary course of business (in which case the gain on the appreciation provision is treated as gain from the sale of a §1221(1) asset).[30]

2. Independent Contractor Rule

Under pre-1986 TRA law, the "75% of income" test is met with gross income derived from, *inter alia*, rents on real property owned by the REIT. However, if services are furnished to the tenants of rented properties, those services must be furnished by an independent contractor in order to have the rents qualify as rents from real property within the meaning of §856(d). The Act ameliorates the strict rule of existing law by placing REITs on the same footing as exempt organizations with respect to unrelated business taxable income. Act §663(a). This means that the REIT no longer needs to engage an independent contractor to provide certain basic services ("customary services") with respect to the property such as the furnishing of heat and light, cleaning of public areas of the property and the collection of trash. *See* Regs. §1.512(b)-1(c)(5) for further examples. The REIT may continue to employ the services of an independent contractor to furnish such "customary services" even though no longer required to do so.[31]

The Conference Report, [32] adds the additional clarifications that: (1) a REIT may operate a free parking lot open to tenants, their guests and customers on an unreserved basis but if a fee is charged the lot must be operated by an independent contractor; and, (2) a REIT may hire and compensate the independent contractors who provide the customary services that may be provided by a REIT in connection with the rental of real property to individual tenants, *e.g.*, cleaning of offices, rather than hiring an independent contractor to hire other independent contractors.[33]

3. Rent or Income Based on Net Income

A REIT will now be allowed to treat certain rents or interest based upon the net income or profits of a tenant or debtor as rents from real property (or as interest from a debtor). Act §663(b)(1). The rent (or interest) will qualify for this treatment if (1) it is received from a tenant or debtor that receives substantially all of its income from either the leased property or the property securing the loan or from either the leasing or subleasing of substantially all of the property, and (2) the rent or interest received by the tenant or debtor consists entirely of amounts which would be treated as rents or interest from real property if it were directly received by the REIT. Act §663. Pre-1986 law, [34] which permitted treatment of a proportionate amount of receipts to be treated as rent or interest from the real property, is retained. The change is a result of a feeling on the part of the Senate Finance Committee that real property lessors who lease to prime tenants on the basis of a fixed amount plus a percentage of profits from the prime's rental of the property should be able to qualify the payments, since the rents are only dependent upon the rents received from the property.[35] This is true even where the rents are based upon the gross receipts of the subtenants.[36]

E. Distribution Requirements

Under pre-1986 TRA law, a REIT must distribute 95% of its taxable income (without regard to any recognized net capital gains) in order to meet the distribution requirement of §857(a), which is based on REIT taxable income ("REITTI"). The Finance Committee noted that a cash method REIT may be required to recognize income in advance of receiving cash where it either sells property in exchange for obligations bearing OID, enters into deferred rental arrangements of the type encompassed by §467, or where the REIT has in good faith engaged in a transaction which it erroneously believes is a §1031 tax-free exchange. Thus, the REIT might have to borrow amounts ranging up to 95% of such income in order to meet its distribution requirement. Senate Report at 780. The TRA-1986 reduces the distribution requirement by the amount that the sum of such noncash types of income exceed 5% of REITTI (determined without regard to the REIT's dividends paid deduction or the net capital gain).[37]

---

[29] Conf. Rep. at II-220-21

[30] Act §662(c) adding new subsection 856(j)

[31] *See* Sen. Rep. at 772-73; cf., Regs. §1.856-4(b).

[32] Conf. Rep. at II-220-21.

[33] Act §663(a) amending §856(d)(2).

[34] §856(d)(4).

[35] *See* Sen. Rep. at 776.

[36] Act §663(b) adding new subparagraph 856(d)(6) and amending subsection 856(f).

[37] Act §664 amending Code §857(a)(1) and adding new subsection 857(e).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

F. Treatment of Capital Gains

1. Liberalization

The pre-1986 TRA general rule that REITs must recognize any capital gain for the taxable year (except to the extent that it pays a capital gain dividend) is modified so that the REIT can compute the net capital gain without an offset for net operating losses ("NOLs"). This rule would apply, regardless of whether the NOL was current or had been carried over from a previous year. If the REIT elects to pay capital gains dividends in excess of its net income, the REIT's NOL carryover will be increased by the amount of the dividend. Act §665(a) amending Code §857(b)(3)(C) and adding new subparagraph 857(b)(3)(D). The Senate Report [38] stated that, consistent with the conduit theory of REITs, the small individual investor should be entitled to the same capital gain treatment he would receive if he held the real estate asset directly.

2. Notice of Capital Gains Dividend

Notices of capital gains dividends which previously had to be mailed to shareholders within 30 days of the end of the REIT's taxable year, may now be sent with the annual report, if one is furnished.[39]

G. Prohibited Transactions

1. Safe Harbor Rules Liberalized

Prohibited transactions, such as the sale by a REIT of excess amounts of property held primarily for sale in the ordinary course of business, are subject to a 100% tax on net income from the prohibited transaction. The "safe harbor" provided by §857(b)(6)(C) of pre-1986 TRA law permitting not more than five such sales (other than foreclosure property) during the taxable year is raised to seven sales, provided the property has been held at least four years. Act §666(a) amending §857(b)(6)(C). The aggregate amount of permitted expenditures (includible in the property's basis) during that period has been raised from 20% to 30% of the selling price. Act §666(a)(2). A new alternative safe harbor rule permits a REIT to make an unlimited number of property sales during the taxable year as long as the adjusted bases of the properties sold do not exceed 10% of the total adjusted basis of all the REIT's properties at the beginning of the year and substantially all of the marketing and development expenditures for each property are made through an independent contractor.[40]

2. Effect of Net Loss

Losses from prohibited transactions as well as deductions attributable to such transactions where a loss was incurred, are not to be taken into account in determining net income derived from prohibited transactions. However, the net loss from a prohibited transaction may be taken into account in computing REITTI.[41]

H. Effective Date

The rules set out by Act §§661-69 are generally effective for taxable years beginning after December 31, 1986. Whether they will have a perceptible effect on the popularity of REITs as a vehicle for real estate investment is difficult to predict. With the limitations imposed on the partnership form of multiple ownership by the Act, Congress may find it necessary to further relax the REIT tax rules in order to achieve a satisfactory level of real estate investment and development.

[38] Sen. Rep. at 777.
[39] Act §665(b) amending §857(b)(3)(C) and §858(c).
[40] Act §666(a) amending §857(b)(6)(C).
[41] Act §666(b) amending §857(b)(2)(F) and §857(b)(6)(B)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 42

MORTGAGE BACKED SECURITIES: THE "REMIC"

Harrison B. McCawley, Esq.
Silverstein and Mullens
Washington, D.C.

I. Background

The secondary mortgage market is an important segment of the economy. This market allows the originator (original lender) of mortgages to sell the mortgage secured debt instruments acquired to an entity organized for the purpose of acquiring a pool of mortgage secured obligations. This entity, in turn, raises the capital required to acquire the mortgages by issuing its own securities to investors. These securities, whether in the form of debt obligations, shares of stock, partnership interests, or, perhaps the most common of all, certificates of beneficial interest are collateralized by the mortgage secured debt instruments held by the issuing entity. As payments are received by the entity from the mortgagors, they are passed through to the interest holders. This device offers investors attractive returns with a substantial degree of security.

For the market to operate at optimum efficiency, an entity must first be formed to acquire a mass of mortgage obligations sufficiently large to minimize the risk of loss through defaults and foreclosures. Interests in the pool may then be sold to investors in various denominations. This frees up funds for the making of new mortgage loans by the originators, and allows investors who would otherwise be unwilling or unable to enter this market to participate in loans secured by real estate. Under pre-1986 TRA law, corporations were unsuitable for use as the pooling entity for several reasons, the foremost of which was the incidence of two levels of taxation. The type of entity usually availed was of a trust which issued to the investors participatory interests in the form of certificates having the attributes of debt instruments. Some of these were classified as partnerships for tax purposes, while others were treated as trusts. However, a number of federal tax, regulatory and accounting problems existed.

One often used device for the issuance of interests in a pool of mortgages under pre-1986 TRA law was a grantor trust. In this case, one major problem was the possibility of being treated as an association taxable as a corporation. In March of 1985, Treasury issued Regs. §301.7701-4(c)(1) (applicable to interests issued after April 27, 1984). Before this time, Regs. §301.7701-4(c) provided only that a management trust having power to vary the investment of the certificate holders is an association taxable as a corporation, and that such a trust lacking such power will be treated as a trust. The 1985 regulations amended these provisions by adding that a trust with only one class of ownership interests representing undivided beneficial interests in the trust assets will usually be treated as a trust if there is no power to vary the certificate holders' investments. The regulation further stated, however, that multiple classes of ownership will ordinarily result in classification as an association or partnership under §301.7701-2. However, it is further provided that trust status will be accorded even if there are such multiple classes (and no power to vary holders' investments) if it is formed to facilitate direct investment in the trust assets and the existence of multiple classes of ownership is "incidental to that purpose." Thus, some mortgage pool arrangements could qualify. There remained, however, a degree of uncertainty. The Conference Committee [1] observed that under these regulations, "if a trust held a portfolio of mortgages, and interests in the trust assets were divided so that one class of beneficiaries were to receive all principal collected by the trust and a specified rate of interest thereon until the trust had collected a specified amount of principal on the mortgages, and another class of beneficiaries were to receive all remaining amounts collected by the trust, then such trust would be treated as an association taxable as a corporation."

To avoid this problem, the issuer of interests in a mortgage pool held by a trust had to structure the interests as debt instruments collateralized by the mortgage pool. This, solution, however, was not entirely satisfactory. There was always the danger of these instruments being classified as equity instead of "true debt." To avoid this, some minimum equity in the issuance of the obligations was usually advised in the form of overcollateralization. This, however, reduced the efficiency of the vehicle. Also, it was usually advised to avoid a too-close timing between the receipt by the issuer of the monthly payments on the mortgages and the payments made by it to the security holders which might provide ground for treating the issuer as a mere agent of the investors. As a result, the interest holders were usually paid quarterly with the issuer incurring the risk of reinvesting the funds collected between such quarterly payments. In addition, there was the "phantom income" problem.

The "phantom income" problem arises from the fact that one characteristic of a mortgage-backed security is its being called in before maturity due to the prepayment of some of the underlying mortgages. This will almost inevitably occur as the mortgagors either sell of refinance the property. Where the collateralized debt instruments have been issued at discount, as is often the case, the issuer is entitled to deduct the original issue discount under §163(e). However, in the case where one or more classes of such instruments are statistically almost certain to be called

[1] H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-223 (1986). ("Conf. Rep.").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

before maturity, the calculation of the §163(e) deduction based on the nominal maturity date understates the issuer's real annual interest cost. Neither §163(e) nor §1272 (providing the rules for current inclusion of OID in income of the holder of an OID debt instrument, the rules of which are incorporated in §163(e) by reference) makes any provision for anticipated prepayment based on an analysis of probabilities.

These are some of the problems which caused Congress to conclude that "considerable uncertainty exists concerning several aspects of the Federal income tax treatment of [multiple class arrangements used in the packaging of mortgages]." [2] Therefore, Congress decided to create a new type of vehicle for the issuance of multiple class securities collateralized by real estate mortgages, and to provide a comprehensive set of rules applicable to all transactions relating to the use of such entities. The provisions enacted by the Finance Committee as extensively modified by the Conference Committee (the House bill contained no comparable provisions) were intended to create an exclusive vehicle, accompanied by exclusive tax consequences,[3] for issuing multiple class real estate mortgage-backed securities.

II. Overview

A. The REMIC

The Tax Reform Act of 1986 [4] creates a new entity, the Real Estate Mortgage Investment Conduit ("REMIC"), which, unless otherwise specifically provided, is not subject to tax and is not to be treated for tax purposes as a corporation, partnership, or trust.[5] Its income is taxable to the REMIC interest holders as provided in the REMIC rules.[6] The partnership audit procedures,[7] however, are to apply to REMICs.[8]

A REMIC is any entity, irrespective of how it may be characterized under the law of the jurisdiction in which formed or would be characterized for federal tax purposes absent these provisions, to which a REMIC election applies for the taxable year and all prior taxable years.[9] Its taxable year is a calendar year.[10] A REMIC election may be made, provided certain qualifications are met, on the entity's return for its first taxable year and applies to all subsequent years unless terminated.[11] If an entity ceases to be a REMIC (due to failure to meet the qualifications) at any time during a taxable year, its status is revoked for the entire year and all subsequent years. There are provisions, however, permitting REMIC status to be retained at the discretion of the IRS in the event of inadvertent termination provided the REMIC and all interest holders agree to any adjustments that may be required to carry out the purposes of the REMIC rules.[12]

Qualifications for REMIC status are:

(1) All of the interests in the entity must be either "regular" or "residual" interests (defined below).

(2) There can be only one class of residual interests, and all distributions to such interests must be pro rata.

(3) As of the close of the 4th month after the entity's "startup day" (defined below), and each quarter ending thereafter, substantially all of the assets of the REMIC must consist of "qualified mortgages" and "permitted investments," (defined below).[13]

A "qualified mortgage" is any obligation (including any participation or certificate of beneficial ownership therein) principally (directly or indirectly secured by an interest in real property. It must be *transferred to* the REMIC on or before the startup day, or *purchased by* the REMIC within three months beginning on the startup day. It may also be a "qualified replacement mortgage" or an interest in another REMIC transferred to the REMIC on or before the startup day.[14] The "startup day" is any day selected by the REMIC which is on or before the first day on which interests in the REMIC are issued.[15]

A "qualified replacement mortgage" is any mortgage that would meet the requirements of a qualified mortgage if transferred to the REMIC on or before the startup day, and which is received in exchange for another obligation within three months from the startup day, or in exchange for a "defective obligation" within a 2-year year period beginning with the startup day.[16]

"Permitted investments" is defined as:[17]

(1) a cash flow investment (investments of amounts received under qualified mortgages for a temporary period before distribution to REMIC interest holders),[18]

(2) a "qualified reserve asset," meaning any intangible property held for investment and as part of a qualified reserve fund, (*i.e.*, a fund reasonably required to defray REMIC expenses or amounts due on regular REMIC interests in the event of defaults on mortgages; the amount of the fund is to be promptly reduced as payments are received on mortgages held by the REMIC).[19] Under a special rule, a reserve does not qualify for any taxable year (or subsequent year) if more than 30% of the gross income from reserve assets is from the disposition of property held for less than three months (other than dispositions required

[2] S. Rep. No. 313, 99th Cong., 2d Sess. p. 791 (1986) ("Sen. Rep.").
[3] Sen. Rep. at 791, Conf. Rep. at II-239.
[4] P.L. 99-514, Tax Reform Act of 1986, referred to herein as "the Act." Act §671(a) contains new Code §§860A - 860G; Act §671(b) contains technical amendments to §§856, 593, 7701(a)(19), and 582; Act §672 contains amendments to §1272 (relating to OID rules); Act §673 contains provisions relating to taxable mortgage pools, Act §674 contains amendments to 6049 (relating to returns regarding payments of interest) which are not discussed herein; Act §675 contains the effective dates.
[5] §860A(a).
[6] §860A(b).
[7] Subchapter C of subtitle F; tax treatment of partnership items, §§6221-6233.
[8] §860F(e). These procedures also apply to holders of "residual interests," which is discussed, *infra*.
[9] §860D(a)(1).
[10] §860D(a)(5).
[11] §860D(b)(1).
[12] §860D(b)(2)(A) and (B).
[13] §860D(a)(2)-(4).
[14] §860G(a)(3).
[15] §860G(a)(9).
[16] §860G(a)(4).
[17] §860G(a)(5).
[18] §860G(a)(6).
[19] §860G(a)(7)(A) and (B); Conf. Rep. at II-227.

to prevent default on a regular interest where the threatened default results from defaults on one or more qualified mortgages).[20]

(3) Foreclosure property (property which would be foreclosure property under §856(e) in the hands of a REIT and which is acquired in connection with the default (or imminent default) of a qualified mortgage held by the REMIC). Such property ceases to be foreclosure property one year after the mortgage pool acquired it. §860G(a)(8).

Where a REMIC issues an interest, regular or residual, in exchange for property, the basis of the property in the REMIC's hands is its fair market value at the time of the transfer.[21]

If a REMIC makes a distribution of property with respect to any interest held in it, gain shall be recognized on the distribution in the same manner as if it had sold the property to the distributee for its fair market value. This amount is the basis of the property distributed in the hands of the distributee.[22]

B. Regular Interests

1. In General

A regular REMIC interest is any interest other than a residual interest. There may be two or more classes of regular interests. The terms of a regular interest must be fixed on the startup day, and it must unconditionally entitle the holder to a specified principal amount (or other similar amount).[23] Further, if interest or similar payments are provided, they must be based on a fixed rate (or, to the extent provided in regulations, a variable rate).[24] The interest may provide for payments of principal before maturity contingent on prepayments of qualified mortgages held by the REMIC and other income from permitted investments.[25]

2. Taxation of Regular Interest Holders

A regular interest in a REMIC can be acquired either for cash or in exchange for property conveyed to the REMIC. No gain or loss is recognized to the transferor on the transfer of any property to a REMIC.[26] The adjusted bases of interests (both regular and residual) received in a transfer of property are equal to the adjusted bases of the property transferred. This amount is allocated among the interests received in proportion to their respective fair market values.[27]

A regular interest, whatever its actual form, is treated for tax purposes as a debt instrument, and all amounts includible in gross income by the holder are determined under the accrual method of accounting.[28] Where a regular interest is disposed of, any gain realized is treated as ordinary income to the extent it does not exceed the excess of:

(1) the amount which would have been included in ordinary income if the yield were 110% of the applicable federal rate (determined under §1274(d) without regard to the lowest three-month rate lookback provision of paragraph (2)) as of the beginning of the taxpayer's holding period, over

(2) the amount actually includible in gross income with respect to the interest.[29]

The issue price of a regular interest acquired for cash is the amount paid for the interest. Where the interest was acquired in exchange for property, the issue price is the fair market value of such property.[30] Thus, where the stated redemption price at maturity [31] of the interest exceeds the issue price, there is OID which must be included in income currently under the rules of §1272. Where the issue price of an interest exceeds its adjusted basis, for periods during which the interest is held by the transferor (or by another person whose basis is determined in whole or in part by reference to such transferor's basis (*e.g.*, a controlled corporation to which the interest is transferred in a §351 transaction), such excess is accrued, in the case of a regular interest, in the same manner as market discount under the provisions of §1276(b).[32] Where the adjusted basis of a regular interest exceeds the issue price, the excess is amortizable in the same manner as bond premium under the rules of §171.[33]

In view of the fact that regular interests are treated as debt instruments, §1272 (relating to the current inclusion of OID in income of the holder of an OID instrument) was amended to provide special rules for debt instruments the payment of all or some portion of the principal amount of which is contingent as to time. New §1272(a)(6) [34] provides rules for the determination of the daily portion of OID where the principal is subject to acceleration. Under these rules, there is allocated to each day in the accrual period the excess (if any) of:

(i) the sum of (1) the present value of all remaining payments due as of the close of the period, and (2) payments during the period of amounts included in the stated redemption price of the instrument at maturity over:

(ii) the adjusted issue price of the instrument as of the beginning of the accrual period.[35]

The present value of future payments is determined on the basis of the instrument's original yield to maturity (compounding at the close of each period and adjusted for the length of the accrual period). Also taken into account are events which have occurred before the end of the accrual period and a prepayment assumption determined in the manner prescribed by regulations.[36]

These rules apply to any regular interest held in a REMIC or any qualified mortgage held by a REMIC. They also apply to any other debt instrument if payments

[20] 20 §860G(a)(7)(A)-(C).
[21] §860F(b)(2).
[22] §860F(c)(1) and (2).
[23] §860G(A)(1).
[24] *Id.*
[25] *Id.*
[26] §860F(b)(1)(A).
[27] §860F(b)(1)(B).
[28] §860B(a) and (b).
[29] §860B(c).
[30] §860(G(a)(10).
[31] *See* Prop. Regs. §1.1273-1(b) for a definition of this term.
[32] §860F(b)(1)(C)(i).
[33] §860F(b)(1)(D)(i).
[34] Act §672. Former §1272(a)(6) is redesignated as (7).
[35] §1272(a)(6)(A).
[36] §1272(A)(6)(B)*See* footnote 121 *infra.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

thereunder may be accelerated by reason of prepayments of obligations securing the instrument (or such other events as may be prescribed by regulations).[37]

C. *Residual Interests*

1. *In General*

A residual interest may also be acquired from the REMIC for either cash or property. A residual interest is defined as an interest in a REMIC that is not a regular interest and is designated as a residual interest.[38] As in the case of regular interests, the basis of a residual interest acquired in exchange for property transferred to a REMIC is the basis of the property transferred.[39] Its issue price is determined as is that of a regular interest, *i.e.*, the amount of cash paid for the interest or, where acquired in exchange for property transferred to a REMIC, the fair market value of property transferred.[40] A residual interest has no stated principal amount and no fixed redemption price.

2. *REMIC Taxable Income (Loss)*

The relationship between the holder of a residual interest and the issuing REMIC is similar in many respects to that of a partner and partnership; income and loss of the REMIC is passed-through to the residual interest holders. Such holder takes into account his daily portion of the taxable income or loss of the REMIC for each day during the taxable year the holder held the interest.[41] A ratable portion of the REMIC's taxable income (or net loss) for each calendar quarter is allocated to each day in the quarter, and, this amount is then allocated to the residual interest holders pro rata for each such day.[42] As noted above, there can be only one class of residual interests.

a. *Taxable Income of a REMIC*

Section 860C(b)(1) provides that REMIC taxable income is determined as if it were an individual on the accrual basis with the following modifications:

(i) All regular interests are treated as if they were indebtedness of the REMIC. §860C(b)(1)(A). This will result, generally, in interest deductions for amounts includible in income of the regular interest holders (other than payments of principal),

(ii) If the REMIC holds any market discount bond, such discount must be currently included in income as it accrues using economic (constant interest) accrual as in the case of OID under §1272. §860C(b)(1)(B);

(iii) No income, gain, loss or deduction attributable to a "prohibited transaction" is taken into account. §860C(b)(1)(C). Such income is taxed to the REMIC at a rate of 100% under §860F (discussed below); and

(iv) The deductions referred to in §703(a)(2) (relating to the determination of the taxable income of a partnership) (other than any deduction under §212) are not allowed. §860C(b)(1)(D).

[37] §1272(a)(6)(C).
[38] §860G(a)(2).
[39] §860F(b)(1)(B).
[40] §860G(a)(10).
[41] §860C(a)(1).
[42] 860C(a)(2).

(b) *Net Loss of a REMIC*

The net loss of a REMIC is the excess of the deductions allowable in computing taxable income over the REMIC's gross income, determined with the modifications set forth above in (i) through (iv). §860C(b)(2).

3. *Taxation of Holders of Residual Interests*

The provisions set forth above describe how pass-through principles are applied to residual interest holders. As in the case of a partnership, distributions to such holder by the REMIC are not includible in gross income to the extent such distributions do not exceed the holder's basis in such interest.[43] Where basis is exceeded, however, the distributions are treated as gain from the sale or exchange of the interest.[44]

Also, as in the case of a partnership interest, the basis of a residual interest is increased in the amount of REMIC taxable income passed-through to the holder, and is decreased (but not below zero) by (1) amounts distributed to the holder, and (2) any net loss of the REMIC taken into account by the holder.[45]

The amounts of the REMIC's taxable income passed-through to the residual interest holder are treated as ordinary income.[46] As in the case of a partnership, the amount of a REMIC's net loss taken into account by a holder for any quarter of the REMIC is limited to his adjusted basis in the interest as of the close of the quarter; any loss pass-through disallowed under this limitation may be carried forward indefinitely.[47]

a. *Special Rules for "Excess Accruals"*

The REMIC provisions also limit the amount by which income passed-through to a residual interest holder for any quarter may be offset by net operating losses. In general, the taxable income of such holder for any taxable year may in no event be less than the "excess inclusion" for such year.[48] Excess inclusions are computed on a quarterly basis. The "excess inclusion" for a calendar quarter means the excess of the amount of REMIC income passed-through over the sum of the "daily accruals" with respect to the interest for the days in the quarter the interest was held.[49] Regulations may provide that where a residual interest has no significant value, the "excess accrual" is simply the amount of REMIC income passed-through without regard to daily accruals.[50]

The daily accrual for each residual interest for each quarter of the REMIC is determined by allocating to each day its ratable portion of the product of the adjusted issue price of the interest at the beginning of the quarter and 120% of the long-term applicable federal rate (as determined under §1274(d) as if the interest were a debt instrument). The adjusted issue price is the original issue price increased by the total of all daily accruals for all

[43] §860C(c).
[44] *Id.*
[45] §860C(d).
[46] §860C(e)(1).
[47] §860C(e)(2).
[48] §860E(a)(1).
[49] §860E(c)(1).
[50] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

previous quarters and decreased by any distributions made before the beginning of the quarter.[51]

The above described minimum amount of REMIC income pass-through to be taken into account by a residual interest holder does not apply to any organization to which §593 (relating to certain financial institutions) applies, unless otherwise provided in regulations where necessary to prevent tax avoidance.[52] If a residual REMIC interest is held by an organization subject to the tax imposed by §511 on unrelated business income, any excess inclusion computed with respect to that interest is subject to such tax.[53]

Where residual interests are held by a real estate investment trust (REIT), any excess of the aggregate excess inclusions determined with respect to such interests over the REIT taxable income (within the meaning of §857(b)(2), excluding any net capital gain) are allocated among the REIT shareholders in proportion to the dividends received by them, and any amount so allocated is treated as an excess inclusion with respect to a residual interest held by the shareholder.[54]

b. Treatment of Nonrecognized Gain/Loss

Where the issue price of a residual interest, determined as of the date of issue by the REMIC, exceeds the holder's adjusted basis in the interest, such excess is included in gross income ratably over the anticipated period during which the mortgage pool will be in existence.[55] Where the holder's adjusted basis in the interest received from the REMIC exceeds its issue price, the excess is allowable as a deduction ratably over the same period.[56]

c. Application of the Wash Sale Rule

For purposes of the wash sale rules of §1091, a REMIC residual interest is treated as a security. In applying these rules to any loss claimed on the sale or other disposition of such interest:

(i) Except as provided in regulations, any residual interest and any interest in a taxable mortgage pool (*see* definition below) comparable to a residual interest are treated as substantially identical stock or securities, and

(ii) Subsections (a) and (e) of §1091 are to be applied by substituting "6 months" for "30 days" each place it appears.[57]

d. Procedural Rules

As noted above, a REMIC is treated as a partnership for purposes of subtitle F of subchapter C, which contains the special rules for the tax treatment of partnership items.[58] Also, for purposes of subtitle F, holders of residual interests are treated as partners.[59] The statute further provides that any return required by these partnership audit rules must include the amount of "daily accruals" (discussed in C, 2, a above). The Secretary is directed to prescribe such regulations requiring reporting to residual interest holders by the REMIC as frequently as is necessary or appropriate to permit them to compute taxable income accurately.[60]

D. Prohibited Transactions; Liquidations

A tax is imposed in the amount of 100% of the net income realized by a REMIC from "prohibited transactions."[61] Net income is defined as the excess of gross income from prohibited transactions over the deductions directly connected with them, but there is not taken into account any item attributable to a prohibited transaction on which there was a loss.[62] A "prohibited transaction" is defined as:

(1) Disposition of a qualified mortgage,

(2) Income from nonpermitted assets,

(3) Compensation for services, and

(4) Gain from the disposition of cash flow investments.[63]

The disposition of a qualified mortgage is a prohibited transaction other than pursuant to: (i) the substitution of a qualified replacement mortgage for a qualified mortgage, (ii) a disposition incident to a foreclosure, default, or imminent default of the mortgage, (iii) the bankruptcy or insolvency of the mortgage pool, or (iv) a qualified liquidation (defined below).[64]

A nonpermitted asset is any asset other than a qualified mortgage or a "permitted investment."[65] The latter term means any: (i) cash flow investment, (ii) qualified reserve asset, or (iii) foreclosure property.[66] These terms were discussed in A, *supra*.

Compensation for services means any amount received by the pool representing a fee or other compensation for services. §860F(a)(2)(C).

Finally, with respect to gain from the disposition of cash flow investments, an exception is made for qualified liquidations.[67]

A "qualified liquidation" means a transaction in which the REMIC must adopt a plan of liquidation, sell all of its assets (other than cash) within the liquidation period, and distribute (or credit) all sale proceeds plus cash (except amounts needed to meet claims) to the interest holders on or before the last day of the liquidation period.[68] The liquidation period means the period from the date the plan was adopted through the close of the 90th day after such date.[69]

[51] §860E(c)(2).
[52] §860E(a)(b).
[53] *Id.*
[54] §860E(d).
[55] §860F(b)(1)(C)(ii).
[56] §860F(b)(1)(D)(ii).
[57] §860F(d).
[58] §860F(e).
[59] *Id.*
[60] §860G(c)(3).
[61] §860F(a)(1).
[62] §860F(a)(3).
[63] §860F(a)(2).
[64] §860F(a)(2)(A).
[65] §860F(a)(2)(B).
[66] §860G(a)(5).
[67] §860F(a)(2)(D).
[68] §860F(a)(4)(A).
[69] §860F(a)(4)(B).

E. Miscellaneous Technical Amendments

1. Treatment for REIT Purposes

For purposes of applying the provisions of §856 (relating to REITs), an interest in a REMIC is treated as an interest in real property, and any amounts included in gross income by reason of the holding of such interest is treated as interest. However, if less than 95% of the assets of a REMIC are interests in real property (determined as if the taxpayer held the assets) it is treated as an interest in real property only in the proportion which the assets of the REMIC consist of such interests.[70]

2. Treatment for Section 593 Purposes

Section 593(d)(4) [71] (relating to mutual savings banks and certain other financial institutions) provides that a REMIC interest shall be treated as a qualifying real property loan or, where less than 95% of the REMIC's assets are qualifying real property loans (determined as if the taxpayer held the assets), in the proportion which the REMIC assets consist of such loans.

3. Other Technical Amendments

Amendments similar to those described in 1 and 2, above were made to §7701(a)(19) (defining domestic building and loan association).[72] Also, §582(c) (providing ordinary income or loss treatment of gains and losses from the sale or exchange by a bank of certain property including evidences of indebtedness) was amended to provide that a REMIC interest is to be treated for purposes of that subsection as an evidence of indebtedness.[73]

F. Taxable Mortgage Pools

Act §673 amends §7701 (as amended by Act §201(c)) by adding new subsection (i) (after redesignating (i) as (j)) which contain provisions applicable to "taxable mortgage pools."

In general, a taxable mortgage pool is to be treated as a corporation for tax purposes and may not be included in a consolidated return.[74]

A taxable mortgage pool is defined as any entity (other than a REMIC) if:

> (i) Substantially all of its assets are debt obligations (or interests therein) and more than 50% of these obligations or interests are secured by real estate mortgages (or interests therein),
>
> (ii) The entity is the obligor on debt obligations with two or more maturities, and
>
> (iii) Payments on the obligations referred to in (ii) are geared to receipts from the obligations referred to in (i). Any portion of an entity which meets these qualifications shall be treated as a taxable mortgage pool.[75]

Nothing in §7701(i) is to be construed to treat a domestic building and loan association as a taxable mortgage pool.[76]

For purposes of these rules, equity interests which correspond to varying classes of debt are to be treated as debt to the extent regulations provide.[77]

If a REIT or REIT subsidiary is a taxable mortgage pool, regulations are to provide adjustments similar to those of §860E(d) (discussed above — passing- through to the REIT shareholders the tax consequences of residual interests held by the REIT) to the REIT shareholders.[78]

G. Effective Dates

The amendments made by Act §671 (all of the provisions discussed above except the amendments of §1272 and §7701) apply to taxable years beginning after December 31, 1986.[79]

The amendments made to §1272 apply to debt instruments issued after December 31, 1986 in taxable years ending after that date.[80]

The amendments made by Act §673 (relating to taxable mortgage pools) takes effect on January 1, 1992. It does not apply to any entity in existence on December 31, 1991. This ceases to apply, however, with respect to any entity as of the first day after December 31, 1991 on which there is a substantial transfer of cash or other property to the entity.[81]

For purposes of the extension of the wash sale rules made by §860F(d) (discussed above), the taxable mortgage pool provisions of Act §673 apply to taxable years after December 31, 1986. Act §675(c)(3).

III. Detailed Analysis

A. Basic REMIC Qualifications and Operating Rules

As indicated above, a REMIC's form is irrelevant so long as it meets REMIC qualifications regarding the composition of its assets and the interests issued by it. It can be a corporation, partnership, trust or other organization or simply a segregated pool of assets.[82] Most of the problems outlined in the introduction would appear to have been effectively dealt with and the way cleared for the efficient exploitation of the secondary mortgage market free from encumbering uncertainties regarding tax aspects.

The principle REMIC assets, obligations, including participations or certificates of interest in obligations, secured directly or indirectly by real estate, are referred to as "qualified mortgages," and will usually have been acquired on or before the startup date (*i.e.*, the date on or after which interests in the REMIC may be issued).[83] As of the close of the fourth month after this startup day and as of the end of each quarter thereafter, substantially all of the REMIC assets must consist of qualified mortgages or

[70] §856(c)(6)(D) as amended by Act §671(b)(1); former subparagraph (D) was redesignated as (E).
[71] As amended by Act §671(b)(2).
[72] Act §671(b)(3).
[73] Act §671(b)(4).
[74] §7701(i)(1).
[75] §7701(i)(2)(A) and (B).
[76] §7701(i)(2)(C).
[77] §7701(i)(2)(D).
[78] §7701(i)(3).
[79] Act §675(a).
[80] Act §675(b).
[81] Act §675(c)(1) and (2).
[82] Conf. Rep. at II-226.
[83] §860G(a)(3) and (9).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

permitted investments.[84] "Substantially all" is intended to permit only "*de minimis* amounts of other assets." [85] These qualified mortgages must have been transferred to the REMIC on or before the startup day [86] or have been purchased by it within the 3-month period beginning with the startup day.[87] A regular REMIC interest transferred on or before the startup day is treated as a qualified mortgage.[88] The mortgage portfolio once established as described can never be changed except as specifically provided.

The Committee Report states that stripped coupons or stripped bonds may be treated as qualified mortgages if they are real estate secured obligations, as will interests in grantor trusts to the extent the trust assets would be treated as qualified mortgages.[89] Further, it is intended that interests such as those described in Regs. §301.7701-4(c)(2), Example (2) should be treated as qualified mortgages. In the cited example, there are two classes of certificates evidencing rights to payments from pooled mortgages held by a trust, Class C and Class D. The C holders are entitled to 90% of payments of principal and interest on the mortgages and the D holders to the remainder. In the event of default, the rights of the D holders are subordinated to those of the C holders. The example states that there is a "limited recourse guarantee" running from the issuer of the certificates to the C holders.

Observation: Section 860G(a)(1), which defines regular interest, provides that the terms of such interest must be fixed on the startup day and must unconditionally entitle the holder to receive a specified principal amount (or similar amount). However, the Conference Report [90] states that payment of the principal amount may be made contingent, in effect, on the absence of defaults on mortgages in the collateral pool. The Report adds that an interest will not fail to qualify as a regular interest because payment of the principal (or similar) amount is subordinated to payments on other regular interests in the REMIC "and are dependent upon the absence of defaults on qualified mortgages." [91] Thus, it is intended that regular interests in a REMIC may resemble the types of interests described in Regs. §301.7701-4(c)(2) (Example (2)), discussed above.[92]

The REMIC is entitled to exchange real estate secured obligations held by it for other real estate secured obligations for a 3-month period beginning on the startup day. Also, a "defective qualified mortgage," *i.e.*, a qualified mortgage with respect to which there is a default or threatened default by the obligor,[93] can be exchanged for a qualified mortgage within the 2-year period beginning on the startup day.[94]

[84] §860D(a)(4).
[85] Conf. Rep. at II-226.
[86] §860G(a)(3).
[87] *Id.*
[88] §860G(a)(3)(C).
[89] Conf. Rep. at II-227, footnote 5.
[90] Conf. Rep. at II-228.
[91] *Id.*
[92] *Id.* In footnote 7, it is stated that the status of an interest as a regular interest in this case does not depend on whether the subordinated regular interest is sold or retained.
[93] Conf. Rep. at II-227, footnote 6.
[94] §860G(a)(4)(B)(ii).

The only activities permitted to a REMIC are essentially the collection of payments on the mortgages held by it and the temporary investment of such "cash flow" proceeds before distribution to interest holders in passive type assets yielding interest only. The Committee Report states that a "guaranteed investment contract" would qualify for such an investment. Under this arrangement, the REMIC agrees to turn over collected proceeds to a third party who agrees to return them with interest at times coinciding with the times payments are to be made to the REMIC interest holders.[95]

A "qualified reserve fund" made up of intangible assets is also authorized but is strictly limited to reasonable provisions for payment of expenses and to secure payments on regular interests that may otherwise be delayed or defaulted due to delays or defaults by the obligors on the mortgages in the pool. Funding should take into consideration the creditworthiness of such obligors and any guarantees backing up their obligations (VA, FHA, etc.). The reserve required should reflect the retirement of regular interests.[96] Section 860G(a)(7)(C) specifies that no more than 30% of the gross income of the reserve in any taxable year can be from the sale of assets held for less than three months. An exception to this rule is provided allowing the disposition of reserve assets to prevent default on payment to a regular interest holder where such default results from a default on one or more of the mortgages in the pool.[97]

As will be discussed below, a tax of 100% on the net income from "prohibited transactions" is imposed on the REMIC. §860F(a)(1).

B. REMIC Interests

A REMIC interest can be acquired by: (1) transferring property to the REMIC in exchange for the interest, (2) purchase of the interest from the REMIC, or (3) acquisition of the interest from another holder. The normal basis rules of §1012 apply except that where an interest is acquired in exchange for property transferred to the REMIC, the transferor takes a basis in the interest equal to the basis of the property transferred. Where several interests are acquired, their basis is determined by proration based on fair market value.[98] No gain or loss is recognized by the transferor or the REMIC in such an exchange.[99] The basis of any property *received by the REMIC* in such an exchange is its fair market value determined at the time of transfer.[100] Regulations may provide, however, that in certain circumstances, where the property transferred is a mortgage, basis may be deterined using the fair market value of such property at a reasonable time before the transfer to the REMIC where the mortgage was purchased for the purpose of making such transfer.[101]

Note: As pointed out below, the fair market value of property transferred to a REMIC in exchange for a regular interest is deemed to be the fair market value of the

[95] Conf. Rep. at II-227.
[96] *Id.*
[97] *See* Conf. Rep. at II-228.
[98] §860F(b)(1)(B); Conf. Rep. at II-229-230.
[99] §860F(b)(1)(A); Conf. Rep. at II-229.
[100] §860F(b)(2).
[101] Conf. Rep. at II-230, footnote 9.

REMIC interest issued. This avoids valuation problems to a large extent.

1. Regular Interests

a. In General

As indicated in the Overview, *supra*, a regular REMIC interest, regardless of its form, must have certain characteristics which will permit the issuing REMIC and the holder to determine their respective taxable incomes. The interest is to be treated as a debt instrument in the hands of the holder and as an obligation of the REMIC for purposes of determining the REMIC's taxable income (loss) for each quarter of its taxable (calendar) year. As already noted, it must unconditionally entitle the holder to receive a specified principal (or similar) amount.

A regular interest may be a debt instrument or a share of stock, a partnership interest, an interest in a trust, or any other form permitted by local law. In all cases, however, there must be "a specified amount that could be identified as a principal amount if the interest were in the form of debt." [102] The Committee Report provides as an example a partnership interest where the holder is to receive a specified amount in redemption of the interest and where the income allocated to the interest is a specified percentage of the specified outstanding redemption amount.

To compute the amount includible in income with respect to a debt instrument, it is necessary to determine its issue price, its yield to maturity, and its stated redemption price at maturity. While it is technically possible for a regular interest to have a zero yield, this will, for all practical purposes, never be the case. Where interest (or an amount similar to interest) is payable on a regular interest, it must be paid at a fixed rate or at a rate qualifying as a variable rate under Regs. §1.1275-5 (defining "variable rate debt instruments"). §860G(a). The amounts includible are computed as if the holder were an accrual basis taxpayer irrespective of the method of accounting used for reporting other items of income.[103]

Comment: It must be clearly understood that there is no *direct* correlation between the taxable income of the REMIC and the amounts includible in the income of the holder of a regular interest. The latter must take into account that portion of the REMIC's income that would be taken into account by an accrual basis holder of a debt instrument with terms equivalent to those of the regular interest.[104] The REMIC's deductions for interest and the amounts includible in the income of the regular interest holder will generally coincide since both are governed by the rules relating to the issuers and holders of debt instruments. However, the interest holder must compute the amounts includible in taxable income without regard to the REMIC's actual taxable income for the taxable year (if any).[105]

Regular interests are to be treated as debt instruments for *all purposes* of the Code.[106] Thus, where the "revised issue price" of a debt instrument, defined as the sum of the issue price plus the aggregate amount of OID includible income of all holders (determined without regard to any reductions by reason of payment of acquisition premium),[107] exceeds the holder's basis in the instrument at the time of acquisition, the excess is market discount. The Finance Committee bill provisions relating to mortgage backed securities provided for the recognition of gain or loss upon the transfer of property to a REMIC in exchange for an interest. However, under the Conference agreement, as provided in §860F(b)(1), there is no gain or loss at the time of the exchange. In the case of a regular interest, any excess of the fair market value of the interest over the transferor's adjusted basis in the property transferred to the REMIC is "included in gross income (as determined under rules similar to rules of §1276(b))." [108] In other words, such excess is treated as market discount to be accrued either ratably or on a constant interest basis at the election of the holder during any period the interest is held or is held by any person whose basis is determined in whole or in part by reference to the basis of the interest in the hands of such transferor, *i.e.*, a controlled corporation to which the interest was transferred in a transaction described in §351. The Conference Report makes it clear that such market discount equivalent is to be included in the interest holder's income currently as if an election had been made under §1278(b).[109]

Where the transferor's basis in the property transferred to the REMIC exceeds the fair market value of the interest received in the exchange, the excess is allowed as a deduction under rules similar to those of §171 which relate to the amortization of bond premium. §860F(b)(10(D)(i).

Observation: Note that the equivalents of market discount or bond premium are to be taken into account under rules "similar to" those provided by §§1276(b) and 171. A REMIC regular interest is not a debt instrument; it is treated as if it were a debt instrument. Thus, there is a degree of flexibility in the application of the Code sections referred to. For example, §1278(a)(1)(C)(i), as amended by Act §1803(a)(6) provides that, except as otherwise provided by regulations, the term "market discount bond" shall not apply to any bond acquired by the taxpayer at original issue. In the case of a regular REMIC interest, however, where the equivalent of the stated redemption price at maturity (generally, the stated principal amount or similar amount) exceeds its issue price, it will have OID to be taken into account under rules similar to those of §1272. Even so, it may still have the equivalent of market discount under the rules discussed above.

Example: Property is transferred to the REMIC in exchange for a regular interest with a fair market value of $50,000. The transferor's basis in the property at the time of transfer was $40,000. The interest has a stated

[102] Conf. Rep. at II-228.
[103] §860B(b).
[104] Conf. Rep. at II-231.
[105] *See* Conf. Rep. at II-231, footnote 13 where it is noted that if the amount taken into account by the holder of a regular interest exceeds the income of the REMIC, there is no diminution of the required inclusions for the holder.
[106] Conf. Rep. at II-231.
[107] §1278(a)(4); Prop. Regs. §1.1275-1(h).
[108] §860F(b)(1)(C).
[109] Conf. Rep. at II-232. A similar rule applies to any market discount debt instruments or REMICs held by the REMIC itself. *See* §860C(b)(1)(B). However, in this case, the discount must be accrued on a constant interest basis only as provided by §1276(b)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

redemption price at maturity of $60,000. The issue price of the interest is $50,000. Thus, has $10,000 of O*Id.* It also apparently has $10,000 of market discount. If the rules of §1276(b) are applied, the interest holder may elect to accrue market discount on a constant interest basis. In this case, §1276(b)(2)(A) provides that market discount is accrued under the rules of §1272 as if it were OID and the instrument were issued for an issue price equal to the basis of the taxpayer in the bond immediately after acquisition. Further, where the instrument has OID, its stated redemption price at maturity is treated as equal to its revised issue price (in the case of a newly issue REMIC interest, its issue price). The coordination of the computations of OID and the accrual of market discount is to be effected under regulations which have not been issued to date.[110] How these rules are to be applied to regular REMIC interests is unclear. Regulations are needed for guidance.

The REMIC is subject to the reporting requirements of §1275 (relating to the issuance of OID obligations).[111] Regular interests are to be treated as evidences of indebtedness for purposes of §582(c)(1) (making them noncapital assets in the hands of certain financial institutions). Finally, where the holder's basis exceeds the amount payable at maturity (or, in some instances, an earlier call date) bond premium could be amortized under the rules of §171.[112]

(1) Prepayment Terms

One characteristic of a REMIC regular interest which distinguishes it from most debt instruments is that the *time* (but not the amount) as of which the principal amount is payable may be contingent. As mortgages in the pool are prepaid (resulting primarily from refinancing or sale of the underlying property), the terms of the interest may permit (or oblige) the REMIC to apply the proceeds and/or other income from permitted investments to payment of the principal amount of one or more classes of regular interests. Where such regular interest was issued at discount, and it is probable that some or all of the principal will be paid before maturity, the computation of the OID accruing during each accrual period is distorted since the instrument's yield to maturity can be computed only if there is a known schedule of principal payments. While such contingency as to prepayment does not disqualify an interest, special rules are necessary to permit the issuing REMIC and holder to compute the OID with a greater degree of accuracy than under the §1272 rules as in effect before their amendment.

(2) Basic OID Rules

Under §1272, providing the rules for determining the amount of OID includible in the income of the holder of an OID debt instrument, the instrument's adjusted issue price at the beginning of each accrual period is multiplied by the instrument's yield to maturity (as adjusted to reflect the length of the period). The amount so determined is then reduced by the amount of any qualified periodic interest payable during the period.[113] Assume a debt instrument with an issue price of $85,000 bearing annual interest of 9.5% payable semiannually the stated redemption price at maturity of which is $100,000. There is $15,000 of OID.[114] To determine the daily portion of OID (for purposes of inclusion under §1272(a)(1)) accruing in each six-month accrual period, the yield to maturity must be determined. This is the rate of interest which will produce a present value of $80,000 when applied to discount all payments due under the instrument.[115] This will, of course, depend on the maturity date; the longer the term, the lower the yield. Assume this to be 10.8% compounded semiannually. For the first accrual period, the OID is computed to be $70: ($80,000 × .054) - $4,250 (assuming $4,250 is the amount of qualified interest paid). The daily portion of OID is obtained by dividing $70 by 180 (using a convention of 12 30-day months in a year). The adjusted issue price for determining OID for the next accrual period is $80,070.[116] The holder's basis in the debt instrument is increased by the amount of OID includible in income under the rules of §1272.

(3) Prepayment Situation

Where an OID debt instrument is prepaid, the holder computes gain or loss by treating the premature retirement as a sale or exchange. If the amount received exceeds basis, there is a gain.[117] In the situation described in (a) above, there will always be a gain since the yield on the basis of which OID is computed is less than the actual yield when prepayment is taken into consideration. As a general rule, deductions allowed to the issuer under §163(e) equal the amounts includible in the income of the holder(s).[118] Where the instrument is retired before maturity, the issuer's §163(e) deductions are understated.

Where it is ascertained at the time of issue of a regular REMIC interest issued at discount that such interest will probably be retired (or partially retired) before maturity, special rules are provided under §1272 to insure that the amount of OID computed for each accrual period or portion thereof is not understated.[119] The REMIC will compute the yield to maturity taking into account a prepayment assumption based on factors to be set forth in regulations.[120]

---

[110] §1276(b)(2)(B)(i) and (ii).

[111] Conf. Rep. at II-231. *See* Prop. Regs. §1.1275-3. These rules apply to any debt instrument issued after May 8, 1976 that has original discount (with certain exceptions not applicable to REMIC interests).

[112] *Id.*

[113] *See* Prop. Regs. §1.1272-1(c).

[114] *See* Prop. Regs. §1.1273-1(a). This assumes that the *de minimis* rule of §1273(a)(3) does not apply.

[115] *See* Prop. Regs. §1.1271-1(f).

[116] *See* Prop. Regs. §1.1272-1(e).

[117] *See* below for the provisions treating that portion of the gain approximating unaccrued OID as ordinary income.

[118] The *de minimis* rule of §1273(a)(3) does not apply. Also, the issuer's deduction is not affected by the reduction allowed under §1272(a)(7) where the original holder sells the debt instrument and the acquirer pays an acquisition premium.

[119] §1272(a)(6), as added by Act §672; former §1272(a)(6) is redesignated as (7).

[120] The Conference Report states that it is intended that the prepayment assumption to be used in calculating yields to maturity and, hence, present values of future payments under the §1272(a)(6) rules "will be that used by the parties in pricing the particular transaction." The assumption is determined by the assumed rate of prepayments on qualified mortgages held by the REMIC and the assumed rate of earnings on temporary investment of REMIC cash flow receipts insofar as the rate of return on such investments will affect the timing of payments on regular interests. On the other hand, in accruing OID (or market discount) with respect to mortgages held by the REMIC, only assumptions about the prepayments on such mortgages are to be taken into account. Conf. Rep. at II-238 and footnote 22.

This will be further adjusted where partial prepayments of principal are made during an accrual period. This adjusted yield will then be applied to compute the present values of all payments due under the instrument at the beginning and end of each accrual period. OID for a given accrual period is then determined as the excess (if any) of:

(i) the sum of (1) the present values of all payments due under the interest as of the close of the accrual period and (2) all payments made during the period of amounts included in the stated redemption price at maturity, *i.e.*, all amounts other than qualified periodic interest, over

(ii) the adjusted issue price of the interest at the beginning of the period. §1272(a)(6)(A).

The adjusted issue price is the original issue price plus all amounts includible in the income of any holder (without regard to any reductions by reason of acquisition premium).

Observation: This method resembles the computation of OID in the case of certain debt instruments issued for property calling for fixed or minimum payments within a specified time period under Prop. Regs. §1.1275-4(d)(2)(iv).

This special rule for computing OID is applicable not only to REMIC regular interests, but also to any qualified mortgage held by a REMIC as well as any other debt instrument subject to prepayment by reason of prepayments of other obligations securing such instrument (or, to the extent provided by regulations, by reason of other events).[121]

Where a regular interest is issued in exchange for property, the provisions of §1273(b)(3) apply without regard to whether the interest or the property is publicly traded. This means that the interest's issue price is equal to the fair market value of the property exchanged. The Committee Report [122] states that it is intended that the fair market value of the property is to be determined by reference to the fair market value of the regular interests received in exchange. Thus, where property is transferred to the REMIC, and the regular interests received in exchange have a value of $100,000, this is their issue price (to be allocated among the interests in proportion to their fair market values).

Comment: This assumes that regular interests can be valued fairly readily. For example, pursuant to §1274, if the interest bears coupon interest of 6.5% and its stated principal amount is $50,000, and if, applying the market interest rate of 9%, the interest is valued at $35,000, Thus, it has $15,000 of OID. Where the interest provided is determined to be excessive, the Conference Report states that the interest will not qualify as a regular interest. Thus, if a regular interest is issued in the form of a debt instrument, where it has a coupon rate "substantially in excess of prevailing market interest rates (adjusted for risk)," it is intended that the interest may be treated either as a residual interest or as a combination of a regular and a residual interest.[123]

When a regular interest issued at discount is disposed of, there comes into play a rule similar to that of §1271(a)(2) this provision provides that where a debt instrument with OID is issued with the intention to call before maturity, any gain on disposition which does not exceed the OID as reduced by the amount of OID includible in the income of any holder (without regard to reductions by reason of acquisition premium) is ordinary income. Of course, if the instrument is held to maturity, all of the OID will have been included in the holder's income. In the case of a regular interest disposed of before maturity, it is treated in a similar manner. Any gain is ordinary income to the extent of the amount which would have been includible in the holder's income if the yield had been 110% of the applicable federal rate (a rough approximation of the market interest rate) reduced by the OID includible under the §1272 rules to the date of disposition. In selecting the applicable federal rate, *i.e.*, short, mid or long-term, the prepayment assumption is to be applied.

Note: It is contemplated that payments on regular interests will be made quarterly, as has been the custom with most preenactment mortgage backed securities. The accrual period will, therefore, usually be a calendar quarter. This is reflected in the provisions set forth below relating to residual interests.

2. Residual Interests

a. In General

Section 860G(a)(2) defines a residual interest as an interest in a REMIC *designated as a residual interest* which is not a regular interest. There can be only one class of residual interests and all distributions with respect to them must be pro rata.[124] Such interests have many of the characteristics of partnership interests, and they are treated as such for purposes of subtitle F.[125] This means that the holders will receive a Form K-1 from the REMIC and must report all REMIC items consistently with their treatment by the REMIC in its information return. Application of the rules set forth below may require more frequent reporting to residual interest holders by the REMIC of its income or loss, and regulations are authorized to require REMIC to furnish such information to holders "as frequently as is necessary or appropriate to permit such holders to compute their taxable income accurately." [126]

b. Pass-Through Rules

(1) REMIC Taxable Income (Loss)

The REMIC must compute its taxable income or loss for each calendar quarter in essentially the same manner as an accrual basis individual with modifications similar to those applicable to a partnership (except that deductions under §212 are allowed.) [127] These exceptions provide that (1) regular interests, if not debt instruments, are treated as indebtedness of the REMIC, (2) market discount on any market discount bond is included in income for the year in which such discount accrues, as determined under the rules

[121] §1272(a)(6)(C).
[122] Conf. Rep. at II-232, footnote 14.
[123] Conf. Rep. at II-229.
[124] *Id.*
[125] §860F(e).
[126] §860G(c)(3).
[127] The Conference Report notes that the treatment of such deductions is to be prescribed by regulations. Conf. Rep. at II-234.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

of §1276(b)(2), and §§1276(a) and 1277 do not apply, and (3) there is not taken into account any income, gain, loss or deduction attributable to prohibited transactions.[128] Where the deductions allowed the REMIC exceed its gross income, it has a loss for the quarter.[129]

(2) Amounts Taken Into Account by Interest Holders

The holder of a residual interest takes into account his daily portion of the taxable income or loss of the REMIC for each day during the taxable year the interest is held. The daily portion is determined on a quarterly basis with each day allocated its ratable share of the quarter's taxable income (or loss). This amount is then allocated among the residual interest holders pro rata for each such day.[130]

Example: A REMIC's taxable income for a quarter is $1,000. There are two residual interests. The holder of a 60% interest holds it during the entire quarter. The holder of a 40% interest transfers it halfway through the quarter to another taxpayer. At the quarter's end, the 60% interest holder's daily portions total $600 treated as received ratably over the quarter. Each holder of the 40% interest is treated as receiving $200 ratably over the portion of the quarter in which the interest was held.[131] Income or loss so taken into account are ordinary income or loss.[132] *See* §860C(e)(1).

Rules similar to partnership rules apply to distributions and losses. Distributions to a residual interest holder are not includible in gross income to the extent they do not exceed the holder's adjusted basis in the interest, and to the extent distributions do exceed such basis, they are treated as gain from the sale or exchange of the interest.[133] Note that a residual interest is treated as an evidence of indebtedness for purposes of §582(c).[134]

The amount of loss taken into account by a residual interest holder under these rules is limited to his adjusted basis in the interest at the close of the quarter (or time of disposition, if earlier). The basis is determined without taking into account the net loss for the quarter.[135] Any loss disallowed by this limitation may be carried over indefinitely to succeeding quarters.[136]

The basis of a residual interest holder in his interest is increased by the amount of income taken into account under these rules and is decreased, but not below zero, by (1) distributions and (2) any net loss of the REMIC taken into account.[137]

Note: These adjustments to basis are apparently to be made at the end of each quarter. In some cases, the proper computation of the holder's taxable income will require information to be supplied quarterly by the REMIC. Also, if the residual interest is sold, basis must be adjusted to the date of sale. It is evident that accurate records must be maintained by the REMIC on a quarterly basis to enable it to provide the necessary information.

Example: Assume that A at the beginning of the year holds a 10% residual interest in a REMIC with a basis of $3,000. On June 30, there is a distribution with respect to A's interest of $3,000. The REMIC taxable income (loss) for the four quarters of the year is: $4,000, ($8,000), ($4,000), and $2,000. These data may be made available to interest holders more frequently than annually (as in the case of the partnership Form K-1), and regulations are authorized to require such reporting.[138] There is taken into account under §860C(a) for the first quarter 10% of the REMIC taxable income or $400. The adjusted basis of A in the interest at the close of the quarter is $3,400. For the second quarter, basis is first reduced by the $3,000 distribution. Therefore, as of the close of the quarter, basis is equal to $400. Thus, only $400 of the interest's $800 share of the loss is passed-through. This is carried over to the next quarter. For the third quarter, none of the $400 share of the loss is allowable since A's basis in the interest is still zero. For the last quarter the gain passed-through is $200, but this is offset by the loss carryover from the third quarter (assuming a FIFO carryover rule). For the year, then, A has ordinary income of $400 from the first quarter. He has ordinary loss of $400 from the second quarter. There is no income or loss from the third or fourth quarters, and there is a carryover of $200 from the second quarter and of $400 from the third quarter to be applied against future quarters of the REMIC interest (but only against income of this same interest).

Note: Where a residual interest is disposed of, the basis adjustment on account of the holder's daily portions of income or loss is deemed to occur immediately before the disposition.[139]

(3) Minimum Inclusions in Income

Section 860E(a)(1) generally provides that the taxable income of a residual interest holder for any taxable year shall not be less than the "excess inclusions" for such year.[140] Excess inclusions are determined for each quarter.

To determine the excess inclusion for a calendar quarter, there is first determined the amount taken into account under §860C(a), discussed immediately above. The excess inclusion for any quarter is the excess, if any, of such amount over the sum of the "daily accruals" for the interest during such quarter. To determine this latter amount, there is allocated to each day in the quarter its ratable portion of the product of the interest's adjusted issue price multiplied by 120% of the long-term applicable federal rate (defined by §1274(d)).[141]

The adjusted issue price of a residual interest is its issue price (cash paid or fair market value of interest if received

[128] §860C(b)(1)(A)-(C).
[129] §860C(b)(2).
[130] §860C(a)(2).
[131] Conf. Rep. at II-233.
[132] *Id.*
[133] §860C(c) (1) and (2).
[134] Conf. Rep. at II-233.
[135] *See* Conf. Rep. at II-233.
[136] §860C(e)(2).
[137] §860C(d).
[138] §860G(c)(3).
[139] Conf. Rep. at II-234.
[140] The heading of §860E(a) is "Excess Inclusions May Not Be Offset By Net Operating Losses."
[141] §860E(c)(2). This rate is compounded quarterly. The rate is determined as if the interest were a debt instrument issued on the date the interest was issued by the REMIC. §860E(c)(2)(C).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

in exchange for property transferred to REMIC) increased by the amount of daily accruals for all prior quarters and reduced (but not below zero) by any distributions made with respect to the interest before the beginning of the quarter. §860E(c)(2)(B).

Note: According to the Conference Report at II-234, these minimum inclusion principles prevent the offset of a portion of the net income of the REMIC taken into account by the holder of a residual interest by any net operating losses of the holder (as the heading of §860E(a) implies). Presumably, the amount taken into account under §860C(a) for the taxable year is first determined by taking into account both income and loss quarters before applying these minimum inclusion rules. Thus, they do not prevent the allowance of REMIC losses passed through under the rules of §860C to the extent of the adjusted basis of the holder, nor do they apply to prevent the carryover of such losses where they exceed basis to succeeding quarters. These losses are not "net operating losses."

The above described minimum inclusion rules of §860E do not apply to §593 organizations (mutual savings and similar institutions operated for mutual benefit and without profit) unless the Secretary otherwise determines it appropriate in order to prevent tax avoidance.[142] If the holder of a residual interest is subject to the tax on unrelated business income imposed by §511 (tax-exempt organizations, generally) any excess inclusions are treated as subject to such tax.[143]

To the extent provided by regulations (which may apply in appropriate cases to residual interests issued before the regulations are issued), where a residual interest does not have "significant value," the minimum inclusion rules are to be applied without regard to daily accruals. In other words, the entire amount taken into account is to be treated as unrelated business income or income subject to withholding at the statutory rate in the case of nonresident alien holders.[144] No portion of such income may be offset by net operating losses irrespective of who holds the interest. It is intended that these regulations would not apply where the value of the residual interest is at least 2% of the combined values of the regular and residual interests.[145]

c. Other Rules Relating to Residual Interests

Where the issue price of a residual interest received in exchange for property transferred to a REMIC exceeds the basis in the hands of the transferor of such property at the time of transfer, the equivalent of market discount is taken into account ratably by the holder as ordinary income over the anticipated period during which the mortgage pool will be in existence. This applies also to any holder in whose hands the interest is transferred basis property.[146] In the case where there is the equivalent of bond premium, it may be amortized ratably over the same period.[147]

As noted in the Overview, *supra*, the wash sale rules of §1091 apply to residual interests as if they were securities. Further, except as provided in regulations, all REMIC residual interests (or similar interests in taxable mortgage pools) are treated as substantially identical property. In applying the wash sale rules to residual interests, loss from the disposition of such an interest is disallowed where another interest (or option to acquire such interest) is acquired within six months of the disposition, rather than 30 days as in the case of other securities.[148]

The Conference Report notes that conferees understand that REMIC income allocated to holders who purchased their interests from other holders after a significant change in value could be substantially accelerated or deferred due to a premium or discount. In such cases, it is recognized that modifications of the rules governing the taxation of holders of residual interests may be appropriate where the rules result in such acceleration or deferral.[149] Presumably, the broad regulatory authority granted by §860G(c) will permit such modifications.

Where a residual interest is held by a REIT, excess inclusions under §860E are allocated and passed-through to the REIT shareholders and treated as excess inclusions in their hands, *i.e.*, they may not be offset by any net operating losses.[150]

C. Prohibited Transactions

Under the REMIC rules, the REMIC must, insofar as practicable, be a passive entity which acts as a middleman between the interest holders and the obligors on the real estate secured obligations held by it. Its activities are, therefore, strictly limited. Other than qualified mortgages, it cannot own any income producing assets other than those necessary to the carrying out of its essential functions. Income earned by it which is not considered necessary for this purpose is, in effect, confiscated by a 100% tax.

This tax is imposed on the net income from "prohibited transactions," [151] which term includes the disposition of qualified mortgages, the earning of income from assets which are not "permitted," the receipt of any fees or other compensation for services, and the realization of gain from the disposition of "cash flow investments." [152]

In determining the net income from such transactions, deductions "directly connected" to the transactions are allowed, but if any transaction results in a loss, such loss is not allowed to offset net income from any other transaction, nor may expenses relating to such net loss transactions be deducted in determining net income from any other transaction.[153]

There are certain exceptions to the transactions listed above. For example a qualified mortgage may be disposed of if it meets the requirements of §806F(a)(2)(i)-(iv).[154] The Conference Report notes that payment by the obligor

[142] §860E(a)(2). This exclusion is stated in the Conference Report to reflect concern for the present financial plight of such institutions. *See* Conf. Rep. at II-234.
[143] §860E(b).
[144] Excess inclusions are not eligible for any reductions in the statutory rate. *See* Conf. Rep. at II-235.
[145] Conf. Rep. at II-235.
[146] §860F(b)(1)(C)(ii).
[147] §860F(b)(1)(D)(ii).
[148] §860F(d).
[149] Conf. Rep. at II-233, footnote 15.
[150] §860E(d).
[151] §860F(a)(1).
[152] §860F(a)(2)(A)-(D).
[153] §860F(a)(3); *See* Conf. Rep. at II-230.
[154] *See* I, D, *supra*; Conf. Rep. at II-230-231.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

on a debt instrument is not to be considered as a disposition of the debt instrument.[155]

If a REMIC adopts a plan of complete liquidation and within a period of 90 days from such adoption sells all of its assets and distributes or credits to all interest holders all of the sale proceeds and any other cash in its hands (cash sufficient to meet claims is permitted to be retained) dispositions of assets pursuant to such "qualified liquidation" [156] are not prohibited transactions.

Note: In the event of any distribution by a REMIC, whether or not in liquidation, of an asset to an interest holder, gain is recognized by the REMIC as if it had sold the property to the distributee for its fair market value.[157] Note that no loss may be recognized by reason of such distribution even if the property's value is less than the REMIC's basis in the property. Presumably, any gain recognized by reason of this rule is subject to the 100% tax.

Query: Would such distribution of property in kind in a liquidation disqualify the liquidation? If the property is deemed sold to the distributee, presumably it would not. If the property is loss property, however, the qualified liquidation rules would seem to require its sale by the REMIC within the 90-day liquidation period.

The REMIC is allowed to invest the receipts from its mortgage pool temporarily pending their distribution to interest holders,[158] provided that the proceeds are paid out promptly at the next succeeding regular payment date.[159] Regulations are authorized to prevent unreasonable accumulations of assets.[160] Such investments are "cash flow" investments. The realization of any gain from the disposition of such a cash flow investment is a prohibited transaction and, consequently, is subject to the 100% tax of §806F(a)(1).[161]

Aside from qualified mortgages and cash flow investments, the only other assets a REMIC may possess are "qualified reserve assets, and "foreclosure property." The former are defined as intangible property held for investment as part of a "qualified reserve fund," a fund reasonably required to pay REMIC expenses or as additional security to insure the payment of amounts due to the holders of regular interests in the event of defaults (including late payments) on mortgages in the pool.[162] This fund must at all times reflect what is "reasonable" for these purposes in light of all the circumstances. As mortgages are paid off and as regular interests are retired, the fund must be adjusted.[163]

The Overview, *supra* sets forth the statutory requirement that the fund's gross income from the disposition of assets held for less than three months must not exceed 30% of the fund's total gross income in any taxable year and all subsequent taxable years.[164] Gain on the disposition of a reserve fund asset, however, is not taken into account if the disposition of such asset is required to prevent default on a regular interest where such default is threatened by reason of a default on one or more of the mortgages in the pool.[165]

"Foreclosure property" is property acquired in connection with the default or imminent default of a qualified mortgage.[166] It retains this status for one year after its acquisition. Presumably, this property can be shifted to a qualified reserve fund in appropriate circumstances.

D. Terminations

Clearly, unless the operation of a REMIC is closely monitored by its managers, it may be found in violation of one or more of these various, often highly technical, rules. If the entity is found at any time to own assets other than (except for a *de minimis* amount) qualified mortgages and permitted investments, its status as such [167] will cease, with possibly disastrous tax consequences to the investors. In general, if the entity ceases to be a REMIC at any time during its taxable year, its status is revoked for the entire year and all subsequent years.[168]

Note: Apparently, termination will not result from engaging in prohibited transactions alone. The net income is taxed at 100%, but REMIC status is not affected.

In recognition of these potentially harsh consequences, the statute specifically provides authority to the IRS to grant relief in the event of an inadvertent termination.[169] This is to be accomplished by regulations, to be administered on a case by case basis, requiring that the failure(s) to qualify as a REMIC result from inadvertent, good faith error (and not by reason of any attempt to manipulate the REMIC provisions to gain tax advantages). Steps must be taken by the REMIC promptly as soon as the disqualifying event is discovered to correct the default.[170]

The IRS can simply ignore the failure, or it can condition nonrevocation of REMIC status on the acceptance by the interest holders and the REMIC of sanctions (*i.e.*, treatment of the REMIC as a C corporation for one or more quarters with resulting two levels of tax). Of course, it may be determined that the failures were too serious to qualify for this discretionary relief.

Observation: If the IRS refuses to grant relief under §860D(b)(2) despite a showing that the termination event was inadvertent, and there was a good faith effort to comply with the REMIC provisions, is there any remedy open to the taxpayers affected? Presumably, a court might require relief where it can be established that the refusal was an arbitrary abuse of discretion. However, the statute does not provide for judicial review, and it is unclear in what form such relief may be sought.

---

[155] Conf. Rep. at II-231, footnote 11.
[156] §860F(a)(4).
[157] §860F(c). The distributee takes a basis equal to such fair market value.
[158] §860G(a)(6).
[159] Conf. Rep. at II-227. *See* the Overview for a description of a "guaranteed investment contract," the type of investment specifically suggested as ideal for REMIC cash flow purposes by the conferees.
[160] 860G(c)(1). These regulations also apply to the qualified reserve fund described below.
[161] §860F(a)(2)(D).
[162] §860G(a)(7).
[163] Conf. Rep. at II-227.
[164] §860G(a)(7)(C). Conf. Rep. at II-228.
[165] *Id.*
[166] The statute refers to the definition in §856(e) relating to REITs. §860G(a)(8).
[167] *See* definition of a REMIC, §860D(a)(4).
[168] §860D(b)(2).
[169] §860D(b)(2)(B).
[170] §860D(b)(2)(B)(iii).

E. Technical Amendments

Regular and residual interests in a REMIC are treated as qualifying real property loans for purposes of §593(d) (relating to bad debt reserve qualifications for mutual savings and similar institutions) and §7701(a)(19) (relating to the definition of domestic building and loan association) in the same proportion that the assets of the REMIC would be treated as qualifying real property loans (100% if 95% or more of the REMIC assets during an entire calendar year consist of such loans).[171] The Conference Report notes that it is intended that in the case of residual interests the amount treated as a qualifying real property loan not be in excess of the holder's adjusted basis in the interest.[172]

For REIT purposes, all REMIC interests are treated as real estate assets in the same proportion that the REMIC assets would be treated as real estate assets for purpose of determining REIT status (100% if 95% of the REMIC assets would be treated as real estate assets at all times during the taxable year).[173] In the case of a residual interest, its fair market value, and not the value of the REMIC assets, is used in the §856(c)(5) asset test.[174] All income derived from a regular or residual interest is treated as interest for purposes of applying the REIT provisions.[175]

F. Effective Dates: Taxable Mortgage Pools

The REMIC provisions discussed above apply to taxable years beginning after December 31, 1986. Thus, a REMIC may be organized and January 1, 1987 may be selected as the startup date on which interests can be issued to investors.

It is intended by Congress that REMICs are to be the exclusive means of issuing multiple class real estate mortgage backed securities without the imposition of two levels of taxation.[176] Thus, Act §673 amends §7701 (as amended by Act §201(c)(3)) by adding new subsection (i) which provides that a "taxable mortgage pool" is to be treated as a separate corporation which is not eligible for joining in a consolidated return.

A taxable mortgage pool (TMP) is defined as any entity *other than a REMIC* if (i) substantially all of the assets of the entity consist of debt obligations (or interests therein) of which more than 50% are secured by real estate mortgages, (ii) the entity has outstanding debt obligations in two or more maturities,[177] and (iii) under the terms of these obligations payments due bear a relationship to payments on the debt obligations held by the issuing entity.[178] For purposes of this definition, to the extent provided by regulations, equity interests of varying classes which correspond to maturity classes of debt are treated as debt.[179]

Any portion of an entity which qualifies as a TMP is to be treated as a TMP.[180]

According to the Conference Report "[T]he TMP provisions are intended to apply to any arrangement under which mortgages are segregated from a debtor's business activities (if any) for the benefit of creditors whose loans are of varying maturities." [181]

Excepted from this classification is any domestic building and loan association or any portion thereof.[182]

New §7701(i) to take effect on January 1, 1992. The TMP provisions are not to apply to any entity in existence on December 31, 1991 unless there is a substantial transfer of cash or other property to such entity after such date.[183] Thus, existing entities which would be classified as TMPs may continue to operate under their present tax regime (which, in some cases, may be unclear or unsatisfactory). However, no new mortgage backed security issuing entities meeting these very broad TMP qualifications may be organized after 1991 without submitting to taxation as corporations.

The amendments made to the OID rules (addition by Act §672 of new subsection 1272(a)(6)) apply to instruments issued after December 31, 1986.[184]

For purposes of applying the amendments to the wash sale rules (under which interests in REMICs as well as interests in entities which would qualify as TMPs if organized after 1991), the taxable mortgage pool provisions of Act §673 apply to taxable years after December 31, 1986.[185]

For another discussion of REMICs, *see* Silversmith, "REMICs: A Major Change in the Rules for Issuing Mortgage-Backed Securities," 2 *Tax Mgmt. Real Est. J.* 294 (Dec. 1986).

---

[171] *See* Act §671(b)(2) and (3).
[172] Conf. Rep. at II-237.
[173] *See* Act §671(b)(1).
[174] Conf. Rep. at II-237.
[175] *Id.*
[176] Conf. Rep. at II-239.
[177] The Committee Report notes that obligations having different rights relating to the acceleration of identical maturities would be treated as having different maturities. Conf. Rep. at II-240, footnote 24.
[178] §7701(i)(2)(A).
[179] §7701(i)(2)(D).
[180] Conf. Rep. at II-240.
[181] *Id.*
[182] §7701(i)(2)(C).
[183] Act §675(c)(1) and (2).
[184] Act §675(b).
[185] Act §675(c)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 43

TECHNICAL AMENDMENTS RELATING TO PARTNERSHIPS AND S CORPORATIONS

Samuel M. Maruca, Esq.
Silverstein and Mullens
Washington, D.C.

I. Retroactive Partnership Allocations

A. Background

Section 706(d), added to the Code by §72 of the Tax Reform Act of 1984, mandates that if during any taxable year there is a change in any partner's interest in the partnership, each partner's distributive shares of partnership items for the taxable year shall be determined by regulations. The provision is intended to prevent retroactive allocation of partnership items by, for example, delayed payment of cash expenditures and the allocation of deductions for such expenditures to partners entering at the time of payment. The Treasury has not as yet issued §706(d) regulations.

Under §706(d)(2)(A), certain deductions of cash basis partnerships ("allocable cash basis items") are assigned to partners on an accrual basis, day-by-day, during any year in which there is a change in any partner's interest in the partnership. Section 706(d)(2)(c)(i) states that where any portion of an allocable cash basis item is properly assignable to a prior taxable year, it is assigned to the first day of the taxable year of payment. Such an item is allocable among those who were partners during the period to which it is properly assignable. Amounts allocable to a person who is not a partner on the first day of the year of payment must be capitalized and treated under §755.[1]

B. TRA 1986 Amendment

Apparently some taxpayers have taken the position that, under §706(d), cash basis items attributable to a prior taxable year of the partnership need not be allocated under the general rule unless there is a change in the partners' relative interests in the partnership in the taxable year of payment. Section 1805(a) of the 1986 Act remedies this apparent flaw in the statute by clarifying that (i) the term "allocable cash basis item" is determined without reference to any particular taxable year (*i.e.*, a year in which partners' interests vary) and (2) allocable cash basis items assignable to a prior period are to be assigned to the first day of the current taxable year. Thus, the rules requiring proper assignment to allocable cash basis items now apply regardless of whether there is a variation in the partners' interests in the year of payment.

C. Effective Date

The §706(d) amendments apply to amounts attributable to periods after March 31, 1984.[2]

II. Disguised Sales to Partnerships or Partners

A. Background

The Tax Reform Act of 1984 amended §707(a) to provide that, under regulations, if there is a direct or indirect transfer of property by a partner to a partnership and a related transfer of property by the partnership to a partner, and the transfers, viewed together, are properly characterized as a sale of the property, they will be so treated. The provision was intended to prevent taxpayers from disguising a sale of property as a nontaxable contribution to partnership capital under §721 and a nontaxable distribution under §731.

B. Extension to Property Exchanges

Section 1805(b) of the 1986 Act amends §707(a)(2)(B) to provide that the disguised sale rules apply to transactions properly characterized as exchanges, as well as those characterized as sales. Thus, for example, a transfer of investment real estate to a partnership coupled with a transfer of other investment real estate from the partnership to a partner would be taxed in accordance with §1031 (relating to like-kind exchanges). Any "boot" received by a partner in the transaction would be currently taxable under §1031(b) and the nonrecognition rule of §731(a) would not apply.

C. Effective Date

The amendment to §707(a) generally applies to property transferred after March 31, 1984.[3]

III. Distribution of Partnership and Trust Interests

The 1986 Act places a limitation on the amount of gain recognized by a distributing corporation in a nonliquidating distribution of a partnership or trust interest. For a complete discussion of this amendment, *see* Chapter 37, Section IV, *supra*.

[1] §706(d)(2)(D).

[2] Act §1881; P.L. 98-369 §72(c)(1).

[3] Act §1881; P.L. 98-369 §73(b)(1)(B). *See* §73(b)(2) and (3) of the 1984 Act for special transitional rules.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

IV. Like-Kind Exchanges

A. Background

Section 77 of the 1984 Act amended §1031 to provide that any property received by a taxpayer in a purported like-kind exchange will not be treated as like-kind property unless the property is identified as the property to be received in the exchange, before the day which is 45 days after the transfer of the property relinquished in the exchange, or the property is received within a certain time period. (*See* §1031(a)(3)(B)).

B. TRA 1986 Amendment

In an attempt to avoid potential confusion regarding the 45 day rule, §1805(d) of the 1986 TRA amends §1031(a) to provide that property identified on the 45th day, as well as property identified prior to such day, qualifies as like-kind property (assuming all other §1031 requirements are satisfied with respect to the exchange).

C. Effective Date

The amendment to §1031(a) generally applies to transfers made after July 18, 1984, in tax years ending after that date.[4]

V. Amendments to S Corporation Rules

A. Background

1. Qualified Subchapter S Trusts

Section 1361(c) and (d) permits a "qualified subchapter S trust" to be a shareholder of an S corporation. Section 1361(d)(3) defines a "qualified subchapter S trust" as a trust the terms of which require that, *inter alia*, there be only one income beneficiary during the life of the current income beneficiary. In addition, all of the trust income must be distributed (or required to be distributed) currently to an individual who is a citizen or resident of the United States.[5]

2. Accumulated Adjustments Account

Section 1368(c)(1) provides that in the case of an S corporation that has accumulated earnings and profits, distributions that do not exceed the corporation's "accumulated adjustments account" are tax-free to shareholders to the extent of their adjusted stock basis. The accumulated adjustments account is defined in §1368(e)(1)(A) as an account of the S corporation which is adjusted, generally, in the manner provided in §1367 (relating to adjustments to the basis of S corporation stock).

In general, the accumulated adjustment account is increased by separately and nonseparately computed items of income under §1366(a)(1), and reduced by separately and nonseparately computed items of loss and deduction under §1366(a)(1), and by tax-free distributions to shareholders under §1368.

B. 1986 TRA Amendments

1. Qualified Subchapter S Trusts

The 1986 Act amends §1361(d) to provide that a substantially separate and independent share of a trust treated as a separate trust under §663(c) shall be treated as a separate trust for purposes of the qualified subchapter S trust definitions.[6] The separate share rules of §663 provide generally that for purposes of §§661 and 662 (relating to trusts that may accumulate income or that distribute corpus during the taxable year, *i.e.*, complex trusts), in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries shall be treated as separate trusts.

Note: In the case of a complex trust with multiple beneficiaries that holds corporate stock, the application of the separate share rule could provide significant planning flexibility.

2. Accumulated Adjustments Account

The 1986 Act amends §1368(e)(i) to specify that no adjustment to the accumulated adjustments account shall be made for Federal taxes attributable to any year in which the corporation was a C corporation.[7] Thus, the deduction for Federal taxes for a C corporation year passed through to shareholders in an S corporation year does not reduce the amount that may be distributed tax free to shareholders.

C. Effective Dates

The amendments to §§1361 and 1368 apply to taxable years beginning after December 31, 1982.[8]

---

[4] Act §1881; P.L. 98-369 §77(b)(1). *See* §77(b)(2)-(5) of the 1984 Act for special transitional rules.
[5] §1361(d)(3)(B).
[6] Act §1879(m)(1)(A).
[7] Act §1879(m)(1)(B).
[8] Act §1879(m)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 44

AMENDMENTS RELATING TO COMPLIANCE REVISIONS

John F. Lefevere, Esq.
Silverstein and Mullens
Washington, D.C.

I. Tax Shelter Registration

A. Introduction

The Tax Reform Act of 1984 [1] continued the trend begun with the Tax Equity and Fiscal Responsibility Act of 1982 [2] in strengthening taxpayer compliance through tougher penalty provisions. The 1984 Act created a registration requirement for tax shelters, and penalties for failing to register a shelter, failure to report the tax shelter's identification number, and failure to maintain a list of tax shelter investors.

1. Tax Shelter Ratio Test

As enacted by the 1984 Act, Code §6111(a) requires any tax shelter organizer to register the shelter with the Secretary of the Treasury not later than the day on which interests in the shelter are first offered for sale. For purposes of defining which tax shelters must register, §6111(c)(1) states that a tax shelter is any investment if a reasonable person could infer from the offering representations that the tax shelter ratio for any investor (as of the close of any of the first 5 years ending after the offering date) may be greater than 2 to 1 and which is either a substantial investment, required to be registered under state or Federal securities laws, or sold under a state or Federal registration exemption. For this definition, the term "tax shelter ratio" is defined in §6111(c)(2) as the ratio which the aggregate amount of the deductions and 200% of the credits which are represented to be allowable to any investor under subtitle A [3] for all periods up to and including the close of the taxable year in question bears to the investment base (*i.e.*, the money and adjusted basis of property contributed) as of the close of that year.[4]

Shortly after enactment of the 1984 Act, the Service issued temporary regulations to aid in the interpretation of the tax shelter registration requirement.[5] These temporary regulations indicate that for purposes of calculating the tax shelter ratio, deductions are the amount of gross deductions and other similar tax benefits potentially allowable with no offset for any gross income either derived or expected to be derived from the investment.[6] "Credits" are the gross amount of credits potentially allowable with respect to the investment calculated without regard to any possible tax liability resulting from the investment or any potential recapture of the credits.[7] A deduction or credit is deemed to be represented as potentially allowable if oral or written representations are made at the time of the offering and subsequently through prospectuses and other written material [8] and can also be inferred from the explicit representation of any one tax benefit.[9] If not explicitly represented, the amount of each deduction or credit should be reasonably estimated, including the most accelerated allowable basis for cost recovery deductions under the ACRS.[10]

The tax shelter ratio requirement is also treated as having been met (thereby requiring registration) if the shelter both meets the requirements of §6111(c)(1)(B) and the ratio may be greater than 2 to 1 for any one investor [11] or greater than 2 to 1 under any one method of financing available to the investor.[12]

2. Tax Shelter Penalties

a. Penalty for Failure to Register a Tax Shelter

Section 6707(a) of the Code was enacted in the 1984 Act as a method of enforcing the tax shelter registration requirements. If the person required to register the shelter (*i.e.*, the principal organizer or a participant in the organization) fails to do so on or before the date prescribed under §6111(a)(1), or does file but provides false or incomplete information, a penalty is imposed in an amount equal to the greater of $500 or the lesser of either (a) 1% of the aggregate amount invested in the shelter, or (2) $10,000.[13] Although the penalty for failure to register is excused if the

---

[1] P.L. 98-369.
[2] P.L. 97-248.
[3] Subtitle A contains the income tax provisions of the Internal Revenue Code.
[4] Code §6111(c)(2)(A) and (B).
[5] T.D. 7964, 49 Fed. Reg. 32712 (August 15, 1984).
[6] Temp. Regs. §301.6111-1T, Q&A-6. However, the net loss (if any) attributable to the investment is not deemed to be equivalent to the term "amount of deductions". *Id.*
[7] *Id.*
[8] *Id.*, Q&A-8.
[9] *Id.*, Q&A-9. This rule means that once any tax benefit has been explicitly represented, all deductions or credits typically associated with that investment will be inferred as having been represented as potentially allowable.
[10] *Id.*
[11] *Id.*, Q&A-15.
[12] *Id.*, Q&A-16.
[13] Code §6707(a)(1) and (2). The Senate felt that $500 was an insufficient deterrent and would have increased the penalty to the greater of 1% of the aggregate invested amount or $10,000. *See* S. Rep. No. 313, 99th Cong., 1st Sess. 193-194 (1986) ("Senate Report").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

failure was due to reasonable cause,[14] the $10,000 limitation on the penalty does not apply if the failure to file resulted from intentional disregard of the requirements of §6111.[15]

b. Failure to Furnish Tax Shelter Identification Number

Section 6707(b) was enacted by the 1984 Act as a means of enforcing the requirement under §6111(b)(1) that the tax shelter identification number be furnished both from shelter sales persons (to investors) and by investors claiming tax benefits from the shelter (to the Service). A person who is required to furnish the identification number to each investor (because he sold or transferred an interest in the shelter) but fails to do so must pay a penalty of $100 for each such failure.[16] If the person who is required to furnish the identification number (because he claims tax benefits from the shelter) files a return but fails to include the identification number, he is liable for a penalty of $50 for each such failure, unless the failure is due to reasonable cause.[17]

c. Penalty for Failure to Maintain Lists of Tax Shelter Investors

As part of Congress' attack on abusive tax shelters, §6112 was added by the 1984 Act to require that any person who organizes or sells a potentially abusive tax shelter must maintain a list which (1) identifies each person who is sold an interest in the shelter and (2) such other information as may be required by regulations. A "potentially abusive tax shelter" is one which is required to be registered under §6111 or is determined by regulations to be an entity, plan, or arrangement having the potential for tax avoidance or evasion.[18] The 1984 Act also created, as a means of enforcement, Code §6708. This section subjects any person who fails to maintain an investment list in accordance with §6112 to a penalty of $50 for each such failure, unless the failure was due to reasonable cause and not to willful neglect.[19] Each separate omission of a person required to be identified on the investor list is treated as separate failure subject to penalty,[20] with a maximum penalty of $50,000 for any calendar year.[21]

B. Overview of 1986 TRA Changes

The Tax Reform Act of 1986 modifies the tax shelter ratio test for the purpose of determining when tax shelters should be registered. In addition, it increases the penalties in three areas: failure to register a tax shelter, failure to include the tax shelter identification number on the tax return, and failure to maintain lists of investors in potentially abusive tax shelters.

Note: A Senate provision to impose a user fee on holders of tax shelter interests was dropped in conference. The user fee would have required taxpayers who, with respect to each tax shelter, claimed on their tax returns cumulative net losses (plus three times the value of cumulative tax credits) that exceeded cumulative actual cash invested in the tax shelter to pay a user fee of 1% of the losses claimed and 3% of the credits claimed with respect to that tax shelter. The measure was designed to help raise sufficient revenue to cover the Service's costs of administering the tax shelter law.[22]

C. Detailed Analysis

1. Tax Shelter Registration Ratio

Under the 1986 TRA, a tax shelter organization is required to register its tax shelter with the Service if the ratio of deductions plus 350% of the credits to the cash actually invested is greater than 2 to 1 for the underlying investment.[23] This is accomplished by substituting 350% for the 200% in pre-1986 TRA Code §6111(c)(2)(A).[24] The change raises the percentage of credits from 200% under pre-1986 TRA law, which yields a credit to deduction conversion at a 50% rate of tax, the pre-1986 TRA maximum individual rate. This provision is designed to maintain the proper conversion of credits into deduction-equivalents as a result of the lowering of the individual rates to a maximum of 28% by the 1986 Act.[25] However, the 2 to 1 ratio of §6111 is not changed by the 1986 Act.

This amendment applies to any tax shelter within the meaning of §6111 in which interests are first offered for sale after December 31, 1986.[26]

2. Tax Shelter Penalties

a. Failure to Register a Tax Shelter

Effective on the date of enactment (for tax shelter interests sold after that date) the pre-1986 TRA $10,000 maximum penalty applicable to tax shelters which fail to register with the Service is deleted.[27] Thus, the penalty for failure to register is the greater of 1% of the aggregate amount invested in the shelter, or $500.[28] The $500 figure serves as a minimum penalty. However, with deletion of the $10,000 maximum, the maximum amount of penalty is unlimited (or, more precisely, only limited by the size of the investment in the tax shelter).

This amendment applies to failures with respect to tax shelters in which interests are first offered for sale after the

[14] Code §6707(a)(1). This is a question of fact, taking into account all representations which the organizer knew or should have known about. T.D. 7964, *supra* footnote 5, Temp. Regs. §301.6707-1T, Q&A-4.

[15] Code §6707(a)(2). The determination of intentional disregard is made individually for each tax shelter organizer. Temp. Regs. §301.6707-1T, Q&A-10.

[16] Code §6707(b)(1).

[17] Code §6707(b)(2).

[18] Code §6112(b).

[19] Code §6708(a).

[20] *See* Temp. Regs. §301.6708-1T, Q&A-1 contained in T.D. 7969, 49 Fed. Reg. 34200 (August 29, 1984).

[21] Code §6708(a). However, a separate $50,000 limitation applies to each tax shelter for which a list is required to be maintained. Temp. Regs. §301.6708-1T, Q&A-5.

[22] *See* Senate Report at 192.

[23] Tax Reform Act of 1986, P.L. 99-514, §1531(a).

[24] Act §1531(a), amending Code §6111(c)(2)(A).

[25] *See* H.R. Rep. No. 841, 99th Cong., 2d Sess. II-794 (1986) ("Conference Report") and Senate Report at 193.

[26] Act §1531(b). The original conference bill contained additional language in §1531(b) stating, "take effect on January 1, 1987," but this was struck in the enrolled version.

[27] Act §1532(a), amending Code §6707(a)(2).

[28] *Id.*, creating Code §6707(a)(2)(A) and (B), as revised.

date of enactment of the 1986 Act (*i.e.*, after October 22, 1986).[29]

b. Failure to Report Tax Shelter Identification Number

The penalty for an investor taxpayer who fails to report a tax shelter identification number on his tax return is raised from $50 to $250.[30] However, the exception for failure to report where the failure is due to reasonable cause is retained. The change reflects the belief of the Senate Finance Committee that the $50 penalty is too low.[31] The amendment applies to returns filed after the enactment date of the 1986 Act (*i.e.*, October 22, 1986).[32]

c. Failure to Maintain List of Tax Shelter Investors

Although the 1986 Act retains the $50 per investor penalty for failure to maintain lists of persons who invest in potentially abusive tax shelters as required by §6112, the maximum penalty which may be imposed for such failure in any one calendar year is raised to $100,000.[33] The exception for failure to include an investor name due to reasonable cause (but not willful neglect) remains unchanged, and (unlike the Senate version), the penalty per name omitted remains at $50, rather than being raised to $100 per name.[34] The higher maximum is effective for failures occurring or continuing after the date of enactment of the 1986 Act (*i.e.*, after October 22, 1986).[35]

II. Revised Penalty Provisions

A. Introduction

The actions taken by Congress with respect to penalties in the Tax Reform Act of 1986 evidence a concern that the penalty provisions as previously constituted were disorganized and further that in many cases the penalties were considered to be too low to act as an effective deterrent to the activities penalized. The penalty provisions prior to their amendment by the 1986 are are described below.

1. Penalties for Failure to File Information Returns or Statements and Furnish Copies

a. Failure to File Information Returns or Statements

Section 6652(a) of the Code imposes a $50 fine on a taxpayer's failure, without reasonable cause, to timely file statements and information returns. Specifically, this penalty applies to each failure to file a statement with respect to the amount of payment to another person required by provisions relating to certain information at source,[36] fishing boat operator reporting,[37] information on income tax withheld,[38] failure to make a return required for direct sellers,[39] brokers,[40] the payment of wages in the form of group term life insurance,[41] certain tip reporting,[42] mortgage interest received in a trade or business from individuals,[43] cash received in a trade or business,[44] foreclosures and abandonment of security,[45] exchanges of certain partnership interests,[46] and certain dispositions of donated property.[47] The penalty also applies with respect to a return required by the section relating to the windfall profit tax on crude oil.[48]

The penalty is imposed unless the taxpayer can show that such failure is due to reasonable cause and not to willful neglect.

Under §6652(a)(2), a special, self-assessed[49] penalty applies to any taxpayer who fails to file a statement of payment amounts to third persons required for the payment of dividends,[50] patronage dividends,[51] or interest.[52] The penalty is $50 per failure to file, but the taxpayer is excused from the penalty if he can show that he exercised due diligence in attempting to satisfy the requirement with respect to the statement.

If one or more failures occurs which are governed by the penalties under §6652(a)(1) or (2) and it is shown that the taxpayer intentionally disregarded the filing requirement, a special penalty is imposed. This penalty is not less than 5% of the gross proceeds required to be reported in the case of a broker reporting,[53] and $100 for each failure in the case of returns of direct sellers, mortgage interest received, cash received, and foreclosures and abandonments.[54] In all other situations described above, the penalty shall not be less than 10% of the aggregate amount of the items which are required to be reported.[55] Moreover, the $50,000 limitation does not apply to these penalty amounts.[56]

b. Failure to Furnish Copies to Persons Entitled to Them

Section 6678 imposes a penalty of $50 on each payor or other person who is required to furnish a statement or copy of a statement or return to third parties and fails to do so. The person who so fails may avoid the penalty if he shows that his failure was due to reasonable cause and not to willful neglect, and the maximum penalty for all such failures during a calendar year cannot exceed $50,000.[57] Those reporting situations generally covered by this re-

[29] Act §1532(b).
[30] Act §1533(a), amending Code §6707(b)(2) by substituting $250 for $50.
[31] *See* Senate Report at 194.
[32] Act §1533(b).
[33] Act §1534(a), amending Code §6708(a) by substituting $100,000 for $50,000.
[34] Conference Report at II-795.
[35] Act §1534(b).
[36] Required by Code §6041(a) or (b). (§6652(a)(1)(A)(i)).
[37] Required by Code §6050A(a). (§6652(a)(1)(A)(ii)).
[38] Required by Code §6051(d). (§6652(a)(1)(A)(iii)).
[39] Required by Code §6041A(a) or (b). (§6652(a)(1)(B)(i)).
[40] Required by Code §6045. (§6652(a)(1)(B)(ii)).
[41] Required by Code §6052(a). (§6652(a)(1)(B)(iii)).
[42] Required by Code §6053(c). (§6652(a)(1)(B)(iv)).
[43] Required by Code §6050H(a). (§6652(a)(1)(B)(v)).
[44] Required by Code §6060I(a). (§6652(a)(1)(B)(vi)).
[45] Required by Code §6050J(a). (§6652(a)(1)(B)(vii)).
[46] Required by Code §6050K. (§6652(a)(1)(B)(viii).
[47] Required by Code §6050L. (§6652(a)(1)(B)(ix)).
[48] Code §4997(a). (§6652(a)(1)(C)).
[49] Section 6652(a)(2)(B).
[50] Required by Code §6042(a)(1). §6652(a)(2)(A)(i).
[51] Required by Code §6044(a)(1). (§6652(a)(2)(A)(ii)).
[52] Required by Code §6049(a). (§6652(a)(2)(A)(iii)).
[53] Section 6652(a)(3)(A)(ii)
[54] Section 6652(a)(3)(A)(iii).
[55] Section 6652(a)(3)(A)(i).
[56] Section 6652(a)(3)(B).
[57] Section 6678(a).

quirement track the situations described in A, 1, a, *supra*, with additional requirements for statements furnished by certain pass-thru entities to their interest holders.[58]

Several special penalty provisions exist in this area. Any partner who transfers his partnership interest and receives money or property attributable to inventory or unrealized receivables and who fails to notify the partnership of the exchange as required by §6050K(c)(1) is subject to the $50 per failure penalty.[59] Of greater importance is the penalty imposed upon payors who fail to provide their payees with statements of interest, dividends and patronage dividends. Those who fail to meet this requirement must pay a self-assessed [60] penalty of $50 for each failure unless he can show that he exercised due diligence in attempting to satisfy the requirement.[61]

2. Penalty for Failure to Pay Tax

a. Failure to Pay Tax

Section 6651(a)(2) provides that if a taxpayer fails to pay the tax due on any return specified in §6651(a)(1) [62] on or before the date prescribed for its payment, determined with regard to any extension of time for payment, a penalty is imposed as an addition to tax at a rate of .05% (*i.e.*, one-half of one percent) of the tax if the failure is not for more than one month. This penalty is in the nature of a civil penalty. If the failure continues, the addition to tax continues at the .05% rate for each month (or fractional month), but not in excess of 25%. However, the failure to pay tax penalty is excused if there is reasonable cause and the failure is not due to willful neglect.

b. Coordination of Failure to File Penalty and Failure to Pay Assessed Deficiency Penalty

Code §6651(c)(1)(B) provides a special rule which coordinates the failure to file penalty of §6651(a)(1) and the failure to pay an assessed deficiency penalty under §6651(a)(2). The special rule, which applies if both penalties are imposed, reduces the failure to pay penalty by that amount of the failure to file penalty which is attributable to the tax for which notice and demand has been made but which has not been paid within 10 days of the notice and demand (*i.e.*, to that amount of the assessed deficiency which is overdue). As a practical matter, the special offset rule permits a taxpayer who never files his return to pay a smaller cumulative penalty than one who files a return but files it late. This is because the taxpayer who files late is liable for the total penalty consisting of both the failure to file and the failure to pay the tax penalty, while the taxpayer who never files has his failure to pay penalty reduced by his failure to file penalty as a result of the operation of §6651(c)(1)(B).

3. Negligence and Fraud Penalties

a. Fraud Penalty

Under §6653(b)(1), if any part of any underpayment of income, estate, gift and certain excise taxes which is required to be shown on a return is due to fraud, then a fraud penalty equal to 50% of the total underpayment is imposed. This penalty is in the nature of a civil fraud penalty. In addition, an amount equal to 50% of the interest payable under §6601 [63] is added to the tax due. Subsection (b)(4) provides that in the case of a joint return, the fraud penalty is not imposed on the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

b. Negligence Penalty

The negligence penalty has two components. First, if any part of an income, gift or windfall profit tax underpayment is due to negligence or intentional disregard of the rules and regulations (where there has been no intent to defraud), there is an addition to tax equal to 5% of the underpayment.[64] The second component, contained in §6653(a)(2), provides for an addition to tax of 50% of the interest payable under §6601 for an underpayment of such tax which is attributable to negligence. The negligence penalty is imposed for the period beginning on the last date prescribed for payment of the underpayment (determined without regard to extensions) and ending on the date of the assessment of the tax, or the date of the payment of the tax, if that is earlier.[65] In addition to its statutory imposition on income, gift, and windfall profit taxes, the negligence penalty has also been extended by the Tax Court to the tax on self-employment [66] and by the Service to the accumulated earnings tax.[67]

In 1986, the Sixth Circuit in *Asphalt Products, Inc. v. Comr.*,[68] reversed a Tax Court decision and held that the negligence penalty should only be applied to that portion of the deficiency attributable to the taxpayer's negligence, rather than applying it to the entire underpayment, where the amount of the underpayment substantially exceeded the portion attributable to negligence.

c. Special Negligence Penalty

In the case of interest, dividends, or patronage dividends, §6653(g) provides that if a payment is made by the payor and shown on an information return, and the payee fails to include any portion of the payment in gross income, this failure is treated as negligence, unless the payee can show otherwise by clear and convincing evidence.

[58] Required by Code §6031(b) (partnerships reporting to partners), §6034A (fiduciaries of trusts and estates reporting to beneficiaries) and §6037(b) (S corporations reporting to their shareholders). *See* Code §6678(a)(3)(F).

[59] Section 6678(c).

[60] Section 6678(b)(2)

[61] Section 6678(b)(1).

[62] Generally, this includes all tax returns, since §6651(a)(1) requires that returns be filed if required by subchapter A of chapter 61 (except for information returns required in part III) which encompasses most income, estate and gift tax returns, and also requires returns to be filed under subchapter A of chapter 52 (distilled spirits, wines and beer), subchapter A of chapter 52 (certain tobacco taxes) and subchapter A of chapter 53 (firearms).

[63] Interest on underpayment, nonpayment or extension of time to pay tax are imposed by Code §6601.

[64] Code §6653(a)(1).

[65] Code §6653(a)(2)(B).

[66] *See Zarnow v. Comr.*, 48 T.C. 213 (1967).

[67] *See* Rev. Rul. 75-330, 1975-2 C.B. 496.

[68] 796 F. 2d 843 (6th Cir. 1986).

4. Penalty for Substantial Understatement of Income Tax Liability

A substantial understatement penalty of 10% is imposed under §6661(a) if the taxpayer's tax liability is understated without reasonable cause. The 10% is imposed on the amount of any underpayment which is attributable to the understatement. An understatement is the amount by which the tax which should be shown on the return exceeds the amount of tax which is actually shown (reduced by a §6211(b)(2) rebate.[69] An underpayment is "substantial" if the amount of the understatement for any taxable year exceeds the greater of 10% of the tax required to be shown on the return, or $5,000.[70] In the case of any corporation, other than an S corporation or a personal holding company, the addition to tax is the greater of 10% of the tax required to be shown or $10,000.[71]

The taxpayer, however, may receive some relief from this penalty if there either was (or is) substantial authority for his tax treatment of the item,[72] or he adequately disclosed the relevant facts concerning the item's tax treatment on the return or in a statement attached to the return.[73]

The "substantial authority" standard is stricter than the reasonable basis standard contained in §6653, but less stringent than the "more likely than not" standard, which is based on having a better than 50% chance of being upheld in litigation.[74] Substantial authority is established when the weight of accepted authorities supporting the tax treatment of the item is substantial in relation to the authority supporting the contrary position.[75] Accepted authorities include the Internal Revenue Code, statutes, regulations, court cases and administrative pronouncements (such as Revenue Rulings) tax treaties, (as well as official explanations and regulations to them) and Congressional intent (as reflected in committee reports and floor statements of managers).[76] However, conclusions reached in treatises, legal periodicals, legal opinions and Internal Revenue Service documents (such as General Counsel Memoranda) are not authority, except to the extent that, for example, a private letter ruling is directed to the taxpayer in question.[77] In practice, however, taxpayers take questionable positions on tax returns which are not based on authority, either in the hope of escaping audit or in reliance upon a tax advisor's opinion.

B. Overview

The Tax Reform Act of 1986 adds a new Part II to Subchapter B of chapter 68 dealing with the failure to file certain information returns. Encompassed within Part II are penalties for failure to file certain information returns, failure to furnish certain payee statements and failure to include correct information where an information return or payee statement is furnished. There is also an expanded penalty for failure to pay tax. After due consideration, the 5-percent level of the existing negligence penalty was retained, with the penalty being applied to the entire portion of the underpayment, not just the portion attributable to the negligence. In this regard, the Sixth Circuit opinion in *Asphalt Products Co. v. Comr.*, is overruled by the conference action. The penalty for substantial understatement of tax liability is doubled to 20% in the case of many taxes, including the individual income tax, corporate income taxes and the unrelated business income tax. However, due to conflicting provisions in the Omnibus Budget Reconciliation Act of 1986, it is unclear whether and when a higher 25% penalty will be imposed due to a substantial understatement. Finally, in a technical amendment to the Tax Reform Act of 1984, an amendment to Code §6229 is added which applies the period of limitations for making assessments to an addition to tax or an additional amount imposed under Subchapter A of chapter 68 on partnership items.

C. Detailed Analysis

1. Penalties for Failure to File Information Returns or Statements

By adding new Part II to subchapter B of chapter 68 (§§6721-6724), the 1986 Act consolidates the penalty for failure to file an information return with the Service with the penalty for failure to supply a copy of that information return to the taxpayer and places them in the same subchapter of the Code. The pre-TRA penalty for failure to file an information return with the Service is repealed,[78] as is the pre-TRA penalty for failure to furnish a copy of the information return to the taxpayer.[79] Both committees expressed a desire to make the consequences of noncompliance more easily understood by taxpayers while facilitating administration on the part of the Service, and sought to do this through simplification and consolidation of the penalties.[80] Although the penalty for single failures is kept at $50 per failure, the maximum penalty is raised to $100,000 in each separate category of failure.[81] The committees indicated a belief that the efficacy of the penalties were diminished where there were massive failures to file, but at the same time declined to totally eliminate the maximum amount imposed in light of the disproportionately enormous tax liability which would be suffered in relation to both the taxpayer's culpability and the imposition of other federal penalties.[82] However, where there is intentional disregard of the filing requirement, pre-TRA law (which imposes a higher penalty depending upon the type of return involved, with no stated maximum penalty) was retained.[83]

The penalty for failure to file due to intentional disregard is $100, with no $100,000 limitation.[84] Moreover, this

[69] Code §6661(b)(2)(A).
[70] Code §6661(b)(1)(A).
[71] Code §6661(b)(1))(B).
[72] Code §6661(a)(2)(B)(i).
[73] Code §6661(b)(2)(B)(ii).
[74] *See* Regs. §1.6661-3(a)(2).
[75] Regs. §1.6661-3(b)(1).
[76] Regs. §1.6661-3(b)(2).
[77] *Id.*

[78] Act §1501(d)(1)(A)(i), repealing pre-TRA §6652(a).
[79] Act §1501(d)(2), repealing pre-TRA §6678.
[80] *See* H.R. Rep. No. 426, 99th Cong., 1st Sess. 829 (1985) ("House Report); Senate Report at 175.
[81] *See* Code §6721(a) and Code §6722(a), added by Act §1501(a).
[82] House Report at 829 and Senate Report at 175.
[83] Code §6721(b) and Code §6723(b), added by Act §1501(a). *See* House Report at 830 and Senate Report at 176.
[84] Code §6721(b)(1)(A).

penalty is not taken into account when applying the other penalties, (other than due to intentional disregard), which impose a $100,000 limitation.[85] One example of the higher penalties reflected in Code §6721(b)(1) is with respect to the penalty for a failure to file a return required under §6050I [receipt of more than $10,000 in the course of trade or business from one transaction (or two or more related transactions)] Under §6652(a)(3)(A)(iii) before repeal the penalty for intentional disregard was $100 for each failure. Under §6721(b)(1)(A) the penalty for intentional disregard is $100 per failure or 10% of the aggregate of such failures, which ever sum is greater.

New §6722 imposes a penalty on each failure to furnish a payee statement to the person to whom it is required to be furnished of $50 per failure, with a maximum total penalty of $100,000 for all such failures during a calendar year.[86] A special rule imposes a $50 penalty (for each failure) on any transferor of a partnership interest who fails to furnish the partnership of the exchange of his partnership interest as required by §6050K. However, the statute does not impose a maximum total penalty.[87]

New Code §6723 imposes a penalty for failure to include correct information (whether through the omission of information or the inclusion of incorrect information) on either an information return or on the copy of such a return supplied to the taxpayer, unless the failure was due to reasonable cause and not willful neglect.[88] Each failure results in a penalty of $5.00 with a maximum penalty imposed on the person who failed to include the information of $20,000 for all such failures in any one calendar year.[89] However, a $100 penalty, without maximum penalty amount, applies where the taxpayer has intentionally disregarded the requirement to file accurate information returns.[90] Moreover, the penalty itself does not apply to an information return if the Service has already imposed the penalty for failure under §6676 to supply the correct taxpayer identification number on the same return.[91] The Senate Report indicates that if the Service has imposed the penalty for failure to file an information return, it may not in addition then impose the incorrect information penalty on the same return.[92]

Section 6724 provides definitions and special rules. In the case of interest, dividend, and patronage dividends, where information returns are filed with the Service and statements are furnished to payees, the new law prohibits the separate $100,000 limitations (applied under §§6721 and 6722) and the $20,000 limitation (applied under §6723) from applying to a failure to file one of these types of statements.[93] Moreover, any penalty imposed on such a failure shall not be taken into account in applying those limitations to other penalties, or for applying the limitations on other returns or statements.[94] However, the penalty will not apply if the taxpayer has exercised due diligence in attempting to satisfy the filing requirement.[95] The penalty is self-assessed and not subject to deficiency procedures.[96]

The new law also clarifies that, in 16 separate instances of substantive information reporting requirements in the Code, the requirement to supply a copy of the information return to the taxpayer is triggered by its obligation to file the information return rather than by the actual filing of the return.[97] In the opinion of both committees, this clarified the requirement and refuted the technical argument made by some taxpayers that furnishing the copy to the taxpayer was only required once the person required to supply the copy had actually provided the return to the Service.[98]

Code §6676(a), which imposes a $5 (or $50) penalty on a failure to include a taxpayer identification number (TIN) on any return, statement or other document, was also amended to increase the maximum penalty from $50,000 to $100,000.[99]

With three exceptions, these amendments apply to returns the due date for which (determined without regard to extensions) is after December 31, 1986. In the case of amendments clarifying the penalties for failure to furnish payee statements, the amendments to §6042(c),[100] §6044(e),[101] and §6049(c) [102] apply to returns the due date for which (determined without regard to extensions) is after the date of enactment of the Act (*i.e.*, after October 22, 1986).[103]

2. *Increase in Penalty for Failure To Pay Tax*

a. In General

The 1986 Act increases the penalty for failure to pay tax and the penalty on a tax which has been assessed but not yet paid from one-half of 1% to 1% per month when two specific contingencies have been met.[104] When the higher penalty rate has been established for any month in regard to a particular type of tax and taxable year, the 1% rate is applicable to any penalty for failure to pay taxes for that taxpayer for all subsequent months.[105] The two situations

[85] Code §6721(b)(1)(B).

[86] Code §6722(a), added by Act §1501(a). The definition of payee statement, contained in Code §6724(d)(2) is generally the same as under pre-TRA law, with the exception of the addition of a payee statement relating to the payment of royalties which is required by Code §6050N(a). *See* Code §6724(d)(2)(Q).

[87] Code §6722(b), added by Act §1501(a). In the House and Senate versions of H.R. 3838, the penalty was imposed at a rate of 5% of the amount which should have been reported. *See* House Report at 830 and Senate Report at 176.

[88] Code §6723, added by Act §1501(a). *See* S. Rept. at 176.

[89] Code §6723(a).

[90] Code §6723(b). Higher penalties are imposed for certain failures (identical to those discussed with respect to §6721) due to intentional disregard.

[91] Code§6723(c).

[92] *See* Senate Report at 177. The conference committee adopted the Senate version, with some modifications unrelated to this point, so that presumably this language indicates Congressional intent on the matter. *See* Conference Report at II-778.

[93] Code §6724(c)(2)(A), added by Act §1501(a).

[94] Code §6724(c)(2)(A) and (B).

[95] Code §6724(c)(1)(B).

[96] *See* Code §6724(c)(3) and (4).

[97] Act §1501(c)(1) through (16).

[98] *See* House Report at 831 and Senate Report at 177.

[99] Code §6676(a), as amended by Act §1501(b).

[100] Act §1501(c)(2).

[101] Act §1501(c)(3).

[102] Act §1501(c)(5).

[103] Act §1501(e).

[104] Act §1502(a) amending Code §6651 by adding a new subsection (d) and redesignating pre-TRA subsection (d) as (e).

[105] *See* Conference Report at II-779.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

occur when (1) a notice of intention to levy has been sent pursuant to §6331(d), or (2) notice and levy has been made upon the assets of the taxpayer pursuant to §6331(a), because the Service feels that the collection of the tax is in jeopardy.

In the case of the notice of intention to levy, the 1% penalty amount is imposed for each month or fraction of a month beginning after the day which is 10 days after the date on which the notice is given under §6631(d).[106] In this situation, the increase in penalty rates occurs at the start of the month following the month in which the 10-day period expires. Where the notice and demand are made because the Service feels that the collection is in jeopardy, the increase in the penalty occurs at the start of the month following the month in which notice and demand are made.[107] Thus, when the §6631(a) levy is invoked, the 1% interest rate is imposed for each month (or fraction thereof) beginning after the day on which notice and demand for immediate payment are given under the last sentence of §6631(a).[108]

Example: If notice of levy is given under §6331(d) on April 24, 1987, the ten day period ends on May 4. The 1% rate would begin on June 1, because the increased rate does not begin until the start of the month following the month in which the ten day period ends.

Both committee reports emphasize that the penalty amount will remain at one-half of 1% during the period when the Service makes initial and then repeated attempts to contact the taxpayer by mail. Once the standard mailing cycle has been completed and the Service must switch to more costly methods, such as telephoning and personal visits to the taxpayer, the 1% rate becomes effective.[109]

The changes were made in line with the position of the President's Proposals for tax reform, which advanced the position that those taxpayers who delay the payment of properly owed taxes should be required to pay penalties approximately equal to the overall cost of collecting the delinquent taxes.[110] Thus, once the Service has generally initiated more expensive collection procedures (at the points in the collection process described above), the higher penalties are effective.

The House Ways and Means Committee rejected a "cost of collection charge" system which would have required the taxpayer to pay for the specific costs of specific Service actions which were required to collect delinquent taxes from him.[111] The Senate Finance Committee version of the bill would have required a report from the Treasury Department which described the proposed cost of such a cost of collection charge system,[112] but this was rejected by the conference committee.[113]

The amendments which increase the penalty for failure to pay tax where notice under §6331(d) or notice and demand under §6331(a) has been given apply to failures to pay which began after December 31, 1986, and to failures to pay which began on or before December 31, 1986, if after that date, notice or renotice is given under §6331(d) or notice and demand are given under §6331(a).[114]

b. Coordination of Penalty for Failure to File and Failure to Pay Assessed Deficiency

Section 6651(c)(1)(A) and (B) are rewritten as §6651(c)(1), so that the special offset rule described above is repealed.[115] As rewritten, the coordination of the failure to file and the failure to pay tax shown is improved, because the 5% failure to file penalty during a particular month is reduced by the one-half of 1% failure to pay penalty for the same month.[116] This amendment applies to amounts assessed after December 31, 1986, with respect to failures to pay which begin before, on, or after that date.[117]

3. Negligence and Fraud Penalties

In general, both committees expressed concern that the negligence and fraud penalties were not being applied in a large number of cases in which such an action would have been fully justified.[118] Although the modifications discussed below were designed to improve the operation of both types of penalties, the Reports emphasize that both the Service and the courts share a "significant responsibility" and are expected to ensure that the penalties are fully asserted where appropriate.[119]

a. Fraud

The first component of the fraud penalty, the basic percentage amount, under §6653(b) is raised to 75% by the new law.[120] However, the scope of the fraud penalty is reduced so that it essentially applies only to that portion of the underpayment attributable to the fraud.[121] The House Report indicates that there was concern that the penalty was otherwise an insufficient deterrent to fraudulent behavior, since the same penalty could be imposed on two taxpayers with identical underpayments where one underpayment was attributable wholly to fraud and the other only partially to fraud.[122] The law attempts to accomplish this objective by changing the burden of proof in fraud cases so that once the Service has established that any portion of the underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer can establish that any portion is not so attributable.[123] It was felt that this was a proper approach since the facts necessary to establish that the underpayment is not due to fraud are generally within the taxpayer's control; however, the committees emphasized that it was their intent that the fraud penalty only apply to the portion of the underpayment attributable to fraud.[124]

[106] Code §6651(d)(2)(A), as amended by Act §1502(a).
[107] *See* Conference Report at II-779.
[108] Code §6651(d)(2)(B), as amended by Act §1502(a).
[109] House Report at 832 and Senate Report at 178.
[110] House Report at 831 and Senate Report at 178.
[111] House Report at 832.
[112] Senate Report at 178.
[113] Conference Report at II-779.
[114] Act §1502(c)(1)(A) and (B).
[115] Act §1502(b).
[116] *See* House Report at 832 and Senate Report at 179.
[117] Act §1502(c)(2).
[118] House Report at 834 and Senate Report at 180.
[119] *Id.*
[120] Code §6653(b)(1)(A), as amended by Act §1503(a).
[121] *Id.*
[122] *See* House Report at 834.
[123] Code §6653(b)(2), as amended by Act §1503(a).
[124] House Report at 835 and Senate Report at 182.

The revised fraud penalty makes no change to the second component of the fraud penalty. Thus (in addition to the 75% of underpayment addition to tax) an amount equal to 50% of the interest payable under §6601 is added to tax for the period beginning on the last day prescribed for payment of the underpayment (determined without regard to any extension) and ending on the date of assessment of the tax (or the date of payment, if earlier).[125]

Despite these modifications, the statute of limitations for false or fraudulent returns under §6501(a) is unchanged. Therefore, if a return is filed which is in some respect fraudulent, the statute of limitations never expires as to the whole return.[126] The statute also continues the existing innocent spouse rule in the case of joint returns; the penalty does not apply to the spouse unless some part of the underpayment is due to the fraud of that spouse.[127]

The amendments made with regard to the fraud penalty are effective for returns the due date for which (determined without regard to extensions) is after December 31, 1986.[128]

b. Negligence Penalty

Despite the failure of Senate efforts to increase the rate of the negligence penalty and narrow its application only to the portion of the underpayment of tax due to negligence,[129] the conference agreement did expand the scope of the penalty by applying it to all taxes under the Code.[130]

For the first time, the term "negligence" is given a clear definition. As redrafted, the term includes any failure to make a reasonable attempt to comply with the provisions of the Code.[131] This was intended to encourage Service agents to assert the penalty where its application may have been considered unclear in the past. The committee reports indicate that the term also encompasses any careless, reckless, or intentional disregard of the rules or regulations; however, negligence is not limited to these items. Thus, all behavior which is considered negligent under existing law, as well as any behavior considered negligent by the courts but not specifically included within the law's definition is or remains subject to the negligence penalty.[132] Moreover, the term "disregard" is defined to include any careless, reckless or intentional disregard.[133]

As redrafted by the conference committee, §6653(a)(1) retains pre-TRA law with respect to the 5% rate and application of the penalty amount to the entire amount of the underpayment rather than just to the portion of the underpayment attributable to negligence.[134] The conferees also clarified that the Sixth Circuit decision in *Asphalt Products Co. v. Comr.*[135] inaccurately states existing law and also is of no effect, since the conference agreement provides that once one element of negligence has been demonstrated, the negligence penalty applies to the entire underpayment.[136]

The amendments made with respect to the negligence penalty apply to returns the due date for which (determined without regard to extensions) is after December 31, 1986.[137]

c. Special Negligence Penalty

The penalty for "special negligence" (*i.e.*, failing to include in income that interest and dividends shown on an information return) under Code §6653(g) is expanded to include any failure to show amounts properly that are shown on the information return.[138] As expanded, this measure applies to any item on an information return as defined in §6724(d)(1),[139] a return of partnership income filed under §6031, a return of an S corporation filed under §6037, the return of an estate or trust filed under §6012(a), a return relating to unemployment compensation filed under §6050B, or a return relating to state and local income tax refunds filed under §6050E.[140] If such an amount has been shown on one of the returns specified above, and the payee (or other person with respect to whom the return is made) fails to show that amount on his own return the negligence penalty is imposed on any portion of the underpayment attributable to such failure.[141] More importantly, this failure is treated as negligence in the absence of clear and convincing evidence to the contrary, meaning that the Service can automatically impose the negligence penalty in these situations. For the purpose of this penalty, an information return is any such return under new Code §6724(d)(1) which is now subject to the penalties for failure to provide an information return.[142]

According to the House Report, which accompanies the House version of H.R. 3838, the 5% special negligence penalty is determined at the top marginal rate applicable to the taxpayer.[143] The following example appears in the House Report and would have to be modified to take into account the lower maximum marginal rates as enacted in the 1986 Act:

> *Example:* A taxpayer fails properly to report as income $1,000 that was reported on an information return as interest income, and also fails to report an additional $1,500 of income that is not reported on an information return. Assume that the top marginal rate from the income the taxpayer actually reported is 25%, but that after $1,500 of additional income, the taxpayer will be in the 35% bracket. The $1,000 of income that was

[125] Code §6653(b)(1)(B), as amended by Act §1503(a).
[126] *See* Senate Report at 182.
[127] Code §6653(b)(3), as amended by Act §1503(a).
[128] Act §1503(e).
[129] Senate Report at 180-181.
[130] Act §1503(a) amending Code §6653(a). *See* Conference Report at II-780-782.
[131] Act §1503(a) creating revised Code §6653(a)(3).
[132] House Report at 835 and Senate Report at 181.
[133] Code §6653(a)(3) as amended by Act §1503.
[134] *See* Conference Report at II-782.
[135] *See* text accompanying footnote 33, *supra*.
[136] *See* Conference Report at II-782, footnote 3.
[137] Act §1503(e).
[138] Code §6653(g), as amended by Act §1503(b).
[139] Code §6653(g)(1)(A).
[140] Code §6653(g)(1)(B).
[141] This modifies §6653(a)(1)(A), which applies the negligence penalty to the total underpayment (even where only a portion of the underpayment is due to negligence).
[142] *See* House Report at 835 and Senate Report at 181.
[143] The conference agreement follows the Senate amendment which is the same as the House bill, so that despite the lack of statutory language, the application of the marginal rate appears to have been intended. *See* Conference Report at II-782.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

reported on the information return is considered to be taxed in the 35% bracket. Thus, the penalty is $17.50 ($1,000 x .35 (tax rate) x .05 (penalty rate)).[144]

The amendments affecting the special negligence penalty apply to returns the due date for which (determined without regard to extensions) is after December 31, 1986.[145]

d. Interaction of Fraud and Negligence Penalties

Where the underpayment of tax is partially attributable to negligence and partially to fraud, the negligence penalty does not apply to any portion of the underpayment which has a fraud penalty imposed on it, even though the negligence penalty otherwise generally applies to the entire underpayment.[146] This provision, along with the more precise targeting of the negligence and fraud penalties, were designed to increase the efficiency of the penalties. The Senate Report notes a concern that under existing law imposing the same penalty on two taxpayers having identical underpayments, but due in different degrees to negligence and fraud, is an insufficient deterrent to either type of behavior.[147]

4. Penalty for Substantial Understatement of Liability

a. The Tax Reform Act of 1986

The percentage penalty imposed as an addition to tax for the substantial understatement of tax is doubled to 20% of the amount of the underpayment of tax attributable to the understatement.[148] The types of taxes to which this increase applies include individual income taxes, corporate income taxes, and the unrelated business income tax.[149] The level of the penalty was increased to provide a more sufficient deterrent to those who rely on both the "audit lottery" and reliance on the advice of tax advisors to avoid the penalty.[150] The amendment affecting the substantial understatement penalty applies to tax returns the due date for which (determined without regard to extensions) is after December 31, 1986.[151]

b. Interaction with the Omnibus Budget Reconciliation Act of 1986

In an attempt to bolster the revenue intake from the substantial underpayment penalty, the drafters of the Omnibus Budget Reconciliation Act [152] agreed to amend Code §6661 further by increasing the substantial understatement penalty to 25% of the amount of any underpayment attributable to the understatement.[153] Although the House version would have made the change effective for returns the due date of which are after December 31, 1986,[154] the conference agreement made the increased penalty effective for penalties assessed after the date of enactment of OBRA,[155] and repealed §1504 of the 1986 Act.[156] This legislative scheme would have succeeded except for the fact that President Reagan signed the Omnibus Act on October 21, 1986, one day before he signed the Tax Reform Act of 1986, because of the delay in passing the enrolling legislation on the tax bill.[157] Although technically the higher penalty was overturned by the subsequent signing of the tax bill as to post-1986 returns, it is believed that clarification of the situation will come in a technical corrections bill.[158] In the interim, the Service issued an information release, IR 86-149.[159] The release said that those taxpayers who substantially understated their income tax liability for 1982 and later years will face the 25% penalty beginning with penalties assessed after October 21, 1986. Thus, the increased amount applies to tax returns due after December 31, 1982. However, the release ended by stating that "[a]lthough Congress intended the increased penalty provisions of the Omnibus Budget Reconciliation Act to apply to tax returns due after December 31, 1986, the IRS is studying the effect, if any, of the Tax Reform Act provisions on these returns." [160] This presumably permits the Service to back down from its position in the event that the release incorrectly interpreted the new laws.

5. Period of Limitations for Penalties

A new subsection (g) is added to §6229 so that the provisions concerning the period for making assessments on partnership items also apply to any addition to tax or additional amount imposed under subchapter A of chapter 68 (*i.e.*, §§6651-6662) which will be treated as if such addition or additional amount were a tax imposed by subtitle A. This change, which is a technical correction to the Tax Reform Act of 1984, applies as if included in the provision of that Act to which the correction applies.[161]

III. Information Reporting Requirements

A. Introduction — Pre-1986 TRA Law

The Tax Equity and Fiscal Responsibility Act of 1982 [162] and the Tax Reform Act of 1984 [163] both contain various measures such as criminal and civil penalties and withholding which are designed to create improved taxpayer compliance and to raise revenues. One important weapon has been those provisions relating to information reporting. Generally, these returns are required where a certain type of income (such as tips or mortgage interest receipts) are

[144] House Report at 835.
[145] Act §1503(e).
[146] Code §6653(a)(2), as amended by Act §1503(a).
[147] *See* Senate Report at 180. This Report also directs the service to issue regulations which impose the fraud penalty at the taxpayer's top marginal rate in situations in which both the fraud and negligence penalty apply, but this was part of a statement made in connection with the Senate provision (not enacted) which would have determined the fraud penalty at the highest marginal rate. *Id.* at 182.
[148] Act §1504(a), amending Code §6661(a).
[149] Conference Report at 783, footnote 4.
[150] Senate Report at 182-183.
[151] Act §1504(b).
[152] P.L. 99-509 (hereinafter referred to as OBRA).
[153] OBRA §8002(a), amending Code §6661(a).
[154] *See* H.R. Rep. No. 1012, 99th Cong., 2d Sess. 372 (1986) (the Conference Report on OBRA).
[155] OBRA §8002(b).
[156] OBRA §8002(c).
[157] *See* 5 Tax Mgmt. Wkly. Rept. 1355 (Nov. 10, 1986).
[158] *See* 33 Tax Notes 430, 431 Nov. 3, 1986.
[159] Information Release 86-149 (November 6, 1986), reprinted in 5 Tax Mgmt. Wkly. Rept. 1355 (Nov. 10, 1986).
[160] *Id.*
[161] Act §1881.
[162] P.L. 97-248.
[163] P.L. 98-369.

received in a manner which may not otherwise be susceptible to scrutiny by the Service.

1. Reporting by Brokers

Under Code §6045, certain brokers must file information returns regarding business which they transact for customers, if Treasury regulations so require.[164] For this purpose, a "broker" is a person who stands ready to effect sales to be made by others in the ordinary course of a trade or business.[165] Prior to the 1986 Act, regulations were issued to require reporting of the gross proceeds from the sales of securities, commodities, regulated futures contracts and precious metals.[166] However, real estate transactions have not been included and there was some concern in Congress that a sizeable number of such transactions have been going unreported.

2. Supplying Taxpayer Identification Numbers on Tax Returns

A taxpayer must include his taxpayer identification number (TIN) and, in the case of a taxpayer who is filing a joint return (or is married filing separately) the TIN of his spouse.[167] However, the taxpayer need not include the TIN of a dependent on his return, even if the dependent is a parent, child, or other qualifying dependent.

Members of recognized religious sects (or divisions thereof) which are opposed to the acceptance of private or public insurance, including Social Security, and who meet the requirements of the Secretary of Health and Human Services [168] may apply for exemption from the self-employment tax.[169] If the application is accepted, the applicant can receive the TIN directly from the Service. The Service also administratively provides TINs directly to nonresident aliens, instead of requiring them to procure the numbers directly from the Social Security Administration. However, in other cases, such as foreign students, the TINs are obtained under special procedures of the Social Security Administration.

3. Information Reporting on Royalties

Along with interest, rents, annuities, pensions, and other gains, profits and income, royalties aggregating $600 or more which are made in the course of a payor's business to another person must be reported in an information return.[170] The failure to include the taxpayer's TIN in the return is not subject to penalty and reportable royalty payments are not subject to backup withholding.

4. Information Reporting on the Receipt of Mortgage Interest

Under pre-1986 TRA law, any person who, in the course of his trade or business, receives from any individual mortgage interest which aggregates $600 or more for any calendar year (on any one mortgage) must file an information report with the Service and furnish a statement to the payor.[171] Under temporary regulations, the Service has required that the receipt of mortgage interest by a cooperative housing corporation be reported to the Service on an information return, with a statement furnished to the tenant-stockholder making the payment.[172] However, the Service suspended this requirement for calendar year 1985 in Announcement 86-3, pending modification and clarification of the temporary regulations.[173]

5. Information Reporting Requirements for Passthrough Entities

The fiduciary of a trust or estate who prepares that entity's income tax return must furnish a statement containing any information which the Service requires to be disclosed by regulations to each beneficiary who receives a distribution from the trust or estate (with respect to the taxable year at issue), and to each beneficiary to whom any item of income (with respect to the taxable year at issue) is allocated.[174] However, if a person holds an interest as the nominee of a beneficiary, the fiduciary is required to furnish the information to him.

The same rules apply to holders of partnership interests.

6. Mailing Requirements for Certain Payee Statements

In the case of payments of dividends, patronage dividends, and interest, the payor must furnish the payee with a statement of the payment either in person or by separate mailing via first class mail.[175] The form for reporting is, in each of the three cases, determined by the Service's regulations. In general, nothing more than an information report has been permitted to be enclosed in a mailing.

7. Tax-Exempt Interest Reporting Requirements

The regulations under Code §265 require that any taxpayer who has deductions allocable to any class of exempt income (or any property or activity where its income is not required to be included in gross income) must attach an itemized statement with his tax return. The statement must show the amount of each class of income and show the allowable deductions allocable to each class.[176] However, tax-exempt interest need only be reported by those taxpayers receiving Social Security benefits which are taxable.

B. Overview

Largely as a result of the need to raise additional revenues as part of the "revenue neutral" goal of the 1986 tax reform legislation, Congress again strengthened the information reporting rules. The 1986 Act imposes reporting requirements on real estate brokers, the head of each

[164] Code §6045(a).
[165] Regs. §1.6045-1(a)(1).
[166] *See* Regs. §1.6045-1(a)(9).
[167] Code §6109.
[168] *See* Code §1402(g).
[169] *Id.*
[170] Code §6041(a).
[171] Code §6050H(a).
[172] Temp. Regs. §1.6050H-1T, Q&A-10.
[173] Announcement 86-3, 1986-3 I.R.B. 42.
[174] Code §6034A.
[175] *See* Code §6042(c) (dividends), §6044(e) (patronage dividends) and §6049(c) (interest).
[176] Regs. §1.265-1(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Federal executive agency engaged in government contracting, and persons paying royalties exceeding $10 per year. For the first time, taxpayer identification numbers (TIN) will have to be supplied for dependents claimed on tax returns, unless the dependent is less than five years old. Those who are currently exempted from social security self-employment taxes may continue to obtain their TINs from the Service.

Tax-exempt income must now be reported on a tax return if the taxpayer is required to make a return of income under §6012. In addition, more specific content rules are created for the separate mailing requirement for certain information reports.

A technical correction to the 1984 Act requires the nominee of a partnership interest owner to furnish the name of the true owner and such other information as the Secretary may require through regulations. Another technical corrections section requires that the same information be furnished to a trust or estate by the nominee of a person holding an interest in that trust or estate.

Note: A House provision which would have required state and local governments which impose income tax to provide information returns to both the individual taxed and the Service was defeated in conference.[177]

C. *Detailed Analysis*

1. *Information Reporting on Real Estate Transactions*

The Senate Report stated a concern that a sizeable number of real estate transactions are not being reported on tax returns.[178] As an extension of Regs. §1.6045 (which requires the reporting of the gross proceeds of sales of securities, commodities, regulated futures contracts, and precious metals) the 1986 Act requires that "real estate brokers" report real estate transactions in a return.[179] The statute sets up a hierarchy for determining who is a real estate broker, so that any of the following persons are responsible (in the order in which listed): (1) the person responsible for closing the transaction (including any attorney or title company), (2) the mortgage lender, (3) the seller's broker, (4) the buyer's broker, or (5) a person designated in the Service's regulations.[180] The real estate broker so designated is also considered to be a "broker" for purposes of §6045(c). Treasury is also given the authority to issue regulations which specify who the person responsible for closing the transaction is, as well as uniform rules concerning which person involved in a closing has primary responsibility for the information reporting.[181] The conference report notes that the regulations need not rely upon the presence or absence of a legal obligation at closing. In addition, the conference report suggests that the Service provide guidance to taxpayers well before the effective date of the requirement, including rules on which type of real estate transactions are included and excluded (such as refinancing) from the scope of the requirement, as well as what gross proceeds should be reported.[182]

The reporting is to be done on a Form 1099 similar to that required for other broker transaction reporting. All penalties and related provisions applying to general information reporting requirements for brokers also apply to real estate transaction reporting. In addition, real estate information reporting may be done on magnetic media, including filing by one entity of all magnetic media reports.[183] Moreover, all penalties and related provisions that apply to the general broker reporting requirements also apply to the real estate reporting requirements, since the reporting is mandatory under Code §6045(a) and (b).[184]

As enacted, the real estate transaction will not be subject to backup withholding, except to the extent required by regulations.[185] The Treasury is to provide guidance to taxpayers on how to implement backup withholding with respect to real estate transactions.[186]

These provisions apply to real estate transactions closing after December 31, 1986.[187]

2. *Information Reporting on Federal Agency Contracts*

In yet another reflection of Congress' reaction to public concern over government contractors who avoid paying taxes, the Act imposes a reporting obligation on the heads of federal agencies which enter into contracts with the private sector.[188] The Act requires the head of federal agencies to file an information return indicating the name, address, and taxpayer identification number of each person with which that agency enters into a contract.[189] For this purpose, a "Federal executive agency" is any executive agency (other than the General Accounting Office) as defined in 5 U.S.C. §105,[190] any military department defined in 5 U.S.C. §102,[191] and the United States Postal Service and the Postal Rate Commission.[192] Moreover, the Service is permitted to extend such reporting requirements by regulations to subcontracts under the contracts which are subject to the statute [193] and to licenses granted by executive agencies.[194] Although the law does not prescribe any minimum threshhold amount for contracts, subcontracts and licenses below which the reporting requirements will not apply, the Service is delegated regulatory authority to prescribe classes of contracts or licenses to which the section will not apply.[195]

---

[177] *See* H.R. Rep. 426, 99th Cong., 1st Sess. (1985)(hereinafter H. Rept.).
[178] Senate Report at 313, 99th Cong., 2d Sess. (1986)(hereinafter S.Rept.).
[179] Code §6045(e), added by Act §1521(a).
[180] Code §6045(e)(2)(A)-(E).
[181] Conference Report at II-787.
[182] *Id.*
[183] *Id.*
[184] *Id.*
[185] Code §3406(h)(5)(D), as added by Act §1521(b).
[186] Conference Report at II-787.
[187] Act §1521(c).
[188] Code §6050M, added by Act §1522(a). *See* also Senate Report at 188.
[189] Code §6050M(a).
[190] Code §6050M(b)(1).
[191] Code §6050M(b)(2).
[192] Code §6050M(b)(3).
[193] Code §6050M(c)(2).
[194] Code §6050M(c)(1).
[195] Code §6050M(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

While permitting the Secretary of the Treasury to issue appropriate regulations, the Senate Report suggests that the information returns be filed within a certain time period of signing the contract, such as 30 days, rather than waiting until the end of the calendar year.[196] The Service is delegated authority to require "such other information" as is required in the return;[197] to that end, the Senate indicated that the Service has the authority to require returns to be in such form and at such time as necessary to make it useful as a source of information for collection purposes.[198]

In the case of consolidated returns where each corporation may have a separate taxpayer identification number, the Secretary is given authority to require that the information return include both the corporation's TIN as well as the TIN under which it files its consolidated return, to facilitate the matching of federal contracts with delinquent collections.[199]

The statute states that the provisions apply to contracts and subcontracts entered into (and licenses granted) before, on, or after January 1, 1987.[200] The Senate interpreted this to mean that all contracts signed on or after that date are subject to information reporting, and further that all contracts signed prior to that date are subject to such reporting if they are still in effect on January 1, 1987.[201]

3. Information Reporting on Royalties

In an effort to remedy the lack of specificity in pre-1986 TRA law requirements (and thus combat the appreciably lower reporting levels for royalty income reporting which existed in relation to other types of income), the 1986 Act provides that a person who makes a royalty payment aggregating $10 or more to any other person in a calendar year must provide an information report to the Service, with a copy to the taxpayer.[202] If payments are made to a nominee and the nominee makes payments aggregating $10 or more to another person, the nominee must report the information to the taxpayer and the Service.[203]

The Senate Report gives as examples of the royalties covered by the new law: payments made with respect to the right to exploit natural resources (such as oil, gas, coal, timber, sand, gravel, and other mineral interests), and payments for the right to exploit intangible property, such as copyrights, trade names, trademarks, franchises, books and other literary compositions, musical compositions, artistic works, secret processes or formulas, and patents.[204]

The general rules for information reporting for payments of interest and dividends apply to this new rule. If a payee does not provide the payor with his (payee's) TIN (which for individuals would be the social security number) the royalty payments generally become subject to backup withholding.[205] Thus, overall, the reporting requirements are more specific and the threshold level for reporting is lowered.[206]

The required returns must contain the name and address of the payee and the total annual royalties paid to him, and otherwise comply with the forms and regulations prescribed by the Service.[207] According to the Senate Report, the information report must be provided to the taxpayer by the end of January (of the year following the calendar year of payment) and the report to the Service must be provided by the end of February.[208] Payors who file large numbers of such returns are subject to the Service's rules on magnetic media filing.[209]

The payor must also furnish a statement to the payee showing the name and address of the person required to make the return and the aggregate amount of payments to the payee which are required to be shown on the return. This statement (in a form prescribed by the Service) must be furnished in person or by first class mail (with adequate notice of what it contains) on or before January 31 of the year following the calendar year in which the return is made.[210] The statute does provide certain exceptions to the statement rules. Thus, unless otherwise provided in the regulations, the return and statement rules do not apply to the following persons described in Code §6049(b)(4):[211] (1) a corporation,[212] (2) a §501(a) tax-exempt organization or individual retirement plan,[213] the United States or one of its wholly-owned agencies or instrumentalities,[214] a state, the District of Columbia or United States possession (or one of their instrumentalities, political subdivisions, or wholly-owned agencies),[215] a foreign government (or its political subdivisions, instrumentalities or wholly-owned agencies),[216] or an international organization (or its instrumentalities or wholly-owned agencies).[217]

The royalty reporting requirements also amend Code §6676 to impose the $50 penalty if the payor has failed to include the payee's TIN on the return, unless he can prove he exercised due diligence in attempting to provide the number.[218] Moreover, the backup withholding rules apply to royalty payments.[219]

The royalty reporting provisions apply to payments made after December 31, 1986.[220]

4. Taxpayer Identification Numbers for Dependents

A taxpayer claiming a dependent who is at least five years old on his tax return must report that dependent's

[196] Senate Report at 189.
[197] Code §6050M(a)(2).
[198] *See* Senate Report at 188.
[199] *See* Senate Report at 189.
[200] Act §1522(c).
[201] Senate Report at 189.
[202] Code §6050N(a)(1), added by Act §1523(a).
[203] Code §6050N(a)(2).
[204] Senate Report at 190.
[205] Code §3406(b)(3)(E), added by Act §1523(b)(1).
[206] Senate Report at 190.
[207] Code §6050N(a), added by Act §1523(a).
[208] Senate Report at 190.
[209] Conference Report at II-789.
[210] Code §6050N(b).
[211] Code §6050N(c).
[212] Code §6049(b)(4)(A)
[213] Code §6049(b)(4)(B).
[214] Code §6049(b)(4)(C).
[215] Code §6049(b)(4)(D).
[216] Code §6049(b)(4)(E).
[217] Code §6049(b)(4)(F).
[218] Code §6676(b)(1)(A), as amended by Act §1523(b)(3).
[219] Code §3406(b)(3)(E), as amended by Act §1523(b)(1).
[220] Act §1523(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

taxpayer identification number on the tax return.[221] This law has been nicknamed "TINS for TOTS." The requirement applies to returns the due date for which (determined without regard to extensions) is after December 31, 1987.[222]

The effective date for this requirement was delayed by the conferees for one year from its original date (January 1, 1987) in order to give taxpayers ample time (prior to the first return on which they will be required) to apply for and receive TINs for those dependents who do not have them. Moreover, the delay is intended to give the Service and Social Security Administration sufficient time to publicize the new requirement.[223]

The conferees indicated that the Service can continue its practice of denying deductions for dependents if the taxpayer can not establish that it is proper to claim the person as a dependent.[224] The amendment will be useful in aiding the Service to track down instances where divorced taxpayers have each claimed the same child as a dependent on their own returns and denying the deduction to one or the other parent.

Those individuals who, due to religious beliefs, acquire their TINs from the Service through an exemption from complying with Social Security Administration requirements can continue to do so, according to the conferees. Moreover, the service is permitted to continue its administrative practice of directly issuing TINs to nonresident aliens.[225]

5. Tax-Exempt Interest Required to be Reported on All Returns

Section 6012 is amended by the 1986 Act to require that every person who is required to file a return for a taxable year must include the amount of tax-exempt interest received or accrued during the taxable year in that return.[226] The House Report notes that is requirement is applicable to all taxpayers, including individuals, corporations and others.[227] It is designed to aid in checking compliance with Code §265 and to compile information for possible future tax changes.[228] Moreover, it will help taxpayers calculate the correct taxable amount of Social Security and the new minimum tax.[229]

6. Mailing Requirements for Payee Statements

In the case of dividends,[230] patronage dividends,[231] and interest,[232] the mailing containing the payee statement now contain adequate notice that such statement is enclosed. Moreover, the mailing requirement also applies to the information reporting requirement for royalties added by the 1986 Act (and discussed above).[233] In addition to the information reports and tax forms which the Service under pre-1986 law permitted to be enclosed, the 1986 TRA rules allow the payor to enclose a statement of the taxpayer's specific account with the payor,[234] a check, or a statement explaining why no check is enclosed.[235] Each enclosure and the outer envelope must contain the following statement: "Important Tax return Document Enclosed." However, a mailing will not be deemed to be a complying statement mailing if it encloses any other material (such as advertising, promotional material, or an annual or quarterly report), since such enclosures make it less likely that the taxpayer will recognize the importance of the documents and utilize them in preparing his return.[236]

The mailing requirements are applicable to information returns filed after the date of enactment (*i.e.*, after October 22, 1986).[237]

The 1986 Act also makes the payee statement requirements of banks and collecting agents for foreign items (such as foreign country bond interest and foreign corporation dividends) in excess of $600 which are collected outside of the United States for a citizen or resident of the United States depend upon being required to file the information return rather than having filed the information returns.[238] This requirement applies to returns the due date for which (determined without regard to extensions) is after December 31, 1986.[239]

7. Reporting to Nominees of Passthrough Entities

Section 6034A of the Code was amended to provide that the fiduciary of a trust or estate must furnish to a nominee of a beneficiary the same information which would be furnished to the beneficiary.[240] In addition, the person who holds the estate or trust interest as a nominee for the beneficiary must (in a manner prescribed by Treasury) furnish to the estate or trust the name of the beneficiary, his address and any other information required by the Treasury.[241] In addition, the nominee must (in a manner prescribed by the Treasury) furnish to the beneficiary that information which is provided to him by the trust or estate in accordance with Code §6034(a).[242] These requirements apply to taxable years of trusts and estates beginning after the date of enactment (*i.e.*, after October 22, 1986).[243]

The same requirement is applied to any person who holds an interest in a partnership as a nominee for another person. Thus, Code §6031 is amended to add nominees.[244] As with the nominee of the estate or trust, the nominee of a

---

[221] Code §6109(e), added by Act §1524(a).
[222] Act §1524(c).
[223] *See* Conference Report at II-790.
[224] *Id.*
[225] *Id.*
[226] Code §6012(d) as added by Act §1525(a). Subsection (d) is redesignated as (e).
[227] *See* House Report at 858.
[228] *Id.*
[229] *Id.*
[230] Code §6042(c)(2), as amended by Act §1501(c)(2).
[231] Code §6044(e)(2), as amended by Act §1501(c)(3).
[232] Code §6049(c)(2), as amended by Act §1501(c)(5).
[233] *See* Senate Report at 191.
[234] Such as a year-end statement or summary of the taxpayer's transactions.
[235] *See* Senate Report at 191. An example of why a check is not enclosed might be because a dividend has not been declared payable. *Id.*
[236] *Id.*
[237] Act §1501(e).
[238] Code §6041(d), as amended by Act §1501(c)(1).
[239] Act §1501(e).
[240] Code §6034A, as amended by Act §1875(d)(4)(A)(ii). The Act apparently misstates the number of the section as §1875(d)(3).
[241] Code §6034A(b)(1) as added by Act §1875(d)(4)(A)(iii) (appearing as §1875(d)(3). The pre-TRA §6034A is recodified as §6034A(a) by Act §1875(d)(4)(A)(i).
[242] Code §6034A(b)(2).
[243] Act §1875(d)(4)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

person holding a partnership interest must furnish the partnership with the name, address and other required information about that person, as well as furnishing the information provided by the partnership under §6031 to the person for whom he is nominee.[245] This amendment applies to partnership taxable years beginning after the date of enactment (*i.e.*, after October 22, 1986).[246]

8. Information Reporting by Cooperative Housing Corporation

Congress amended Code §6050H to provide that amounts received from a tenant-shareholder by a cooperative housing corporation will be deemed to be interest received on a mortgage in the course of a trade or business engaged in by the cooperative, to the extent of the tenant-shareholder's proportionate interest as described in Code §216(a)(2).[247] This change is effective as if included in the provision of the Tax Reform Act of 1984 to which it relates.[248] Thus, it applies to mortgage interest received after December 31, 1984 and effectively reinstates the Service's treatment of such interest under the temporary regulations before they were suspended.

IV. Modifications to the Interest Rules

A. Introduction — Pre-1986 TRA Law

1. Interest Rates on Underpayments and Overpayments of Tax

The interest rate which is used to compute interest on either an underpayment of tax [249] (where the taxpayer pays interest to the Service) or an overpayment of tax [250] (where the Service pays interest to the taxpayer) is the same because it is calculated under Code §621. Section 6621(a) provides that the annual interest rate is to be an adjusted rate established by Treasury. The rate (which is set twice a year and in effect for six months) is equal to the average predominate prime rate quoted by commercial banks to large businesses, as determined by the Board of Governors of the Federal Reserve System.[251] This rate is not as reflective of prevailing rates as actual market rates involving other governmental transactions and is unrealistic to the extent that it does not reflect the normal banking practice of lending funds at rates higher than the rates paid for funds.

2. Interest on Accumulated Earnings Tax

In Revenue Ruling 72-324 [252] the Service agreed to follow decisions in the Court of Claims,[253] the Sixth Circuit,[254] and the Ninth Circuit [255] which held that because the accumulated earnings tax is an additional amount or addition to tax under Code §6601(e)(2), interest on the tax does not begin to run until notice and demand for payment is made. Thus, interest is not imposed until there has been no payment of the addition to tax within 10 days of notice and demand for payment. Moreover, the interest only runs from the date of notice and demand until the date of payment of the addition.[256] Thus, there is generally less incentive (from an interest point of view) to report an accumulated earnings tax liability than there is for other types of taxes.

3. Mandatory Imposition of Interest on Unpaid Tax

Under Code §6601(a), it is mandatory that interest be charged whenever any tax or installment of tax has not been paid. The Service has no leeway to excuse the payment of interest, and has refused to do so even where additional interest liability has been created as a result of Service error or delay. The Service's position is that, once the tax liability has been established, the amount of interest is merely a mathematical computation based upon the rate of interest and the due date of the return; it can only be reduced when the underlying deficiency is reduced.[257] However, the Service does have statutory authority to abate interest if it results from a mathematical error of a Service employee assisting a taxpayer in the preparation of a return.[258]

4. Compounding of Interest When Deficiency is Suspended

Code §6622(a) provides that interest on the underpayment of tax is computed by compounding the interest daily. However, if a taxpayer consents to an immediate assessment of income, estate or gift taxes, and pays the tax within 10 days of the notice and demand for payment, interest is stopped on the 30th day after the filing of the taxpayer's consent, if that date is earlier than the date of notice and demand.[259] But interest continues to accrue on previously charged interest, because the Service does not have a statutory mechanism to prevent it.

5. Imposition of Interest on "Tax-Motivated" Transactions

Section 6621 defines the following as tax motivated transactions to which a special high interest rate will be applied: (1) any valuation overstatement within the meaning of Code §6659(c),[260] (2) a transaction in which any loss is disallowed under the at-risk rules or a credit is disallowed for investment tax credit purposes,[261] (3) any tax straddle,[262] (4) any use of an accounting method which, under the Service's regulations, is a use which may result in a substantial distortion of income for any period,[263] or (5) any other type of transaction which the Service's regulations specify will be treated as a tax motivated transaction for purposes of the higher interest rate.[264] The special high

[244] Code §6031 as amended by Act §1811(b)(1).
[245] Code §6031(c), as added by Act §1811(b)(1)(A)(ii).
[246] Act §1811(b)(1)(B).
[247] Code §6050H(g), as added by Act §1811(a)(1).
[248] Act §1881.
[249] Code §6601.
[250] Code §6611.
[251] Code §6621(c).
[252] 1972-1 C.B. 399.
[253] *Motor Fuel Carriers v. U.S.*, 420 F. 2d 702 (1970).
[254] *Ray Loper Lumber Co., Inc. v. U.S.*, 444 F.2d 301 (6th Cir. 1971).
[255] *Bardahl Mfg. Corp. v. U.S.*, 452 F.2d 604 (9th Cir. 1971).
[256] Code §6601(e)(2).
[257] *See* Conference Report at II-810.
[258] Code §6404(d).
[259] *See* Code §6601(c) and §6601(e)(3).
[260] Code §6621(d)(3)(A)(i).
[261] Code §6621(d)((3)(A)(ii).
[262] Code §6621(d)(3)(A)(iii).
[263] Code §6621(d)(3)(A)(iv).
[264] Code §6621(d)(3)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

interest rate imposed on a substantial underpayment attributable to such transactions is 120% of the adjusted rate established under §6621(b).[265] For the last half of 1986, this meant that the special interest rate was 120% of the 10.8% rate which was effective from July 1, 1986, through December 31, 1986.[266]

However, the Tax Court has held that the higher interest rate would not apply to a sham transaction since that type of event is not included in either the statutory definition or the regulations.[267] In the *Forseth* case, the result was even more pronounced since the taxpayer was involved in a sham tax straddle. The court found that the transaction was a straddle in form but not substance, leading to the anomalous holding that a tax-motivated tax straddle is subject to the higher interest rate, but a sham tax straddle (which is arguably more egregious in terms of taxpayer conduct) is not.[268]

B. Overview of the 1986 TRA Changes

The TRA of 1986 creates differential interest rates which are designed to result in a more favorable revenue situation for the government. In addition, interest on accumulated earnings taxes accrues from the date when the original return was due to be filed. The Service is given authority to abate interest which is attributable to errors and delays by Service officers and employees and required to do so in certain instances of erroneous refunds. Moreover, an amendment provides that there will be no compounding when interest on a deficiency on income, estate, gift and certain excise taxes is suspended under §6601(c). Finally, the section (renumbered as §6621(c)) dealing with the interest on substantial underpayments attributable to tax motivated transactions is modified to include any sham or fraudulent transaction within the definition of the term "tax motivated transaction."

C. Detailed Analysis

1. Differential Interest Rates

Under the revised system for calculating interest rates on the underpayment and overpayment of taxes, a one-percent differential is created between the rates payable, favoring the government. Thus, Treasury must pay taxpayers an interest rate on overpayments equal to the federal short-term interest rate plus two percentage points.[269] Where the taxpayers pay interest on underpayments, however, the interest rate is based upon the federal short-term rate plus three percentage points.[270] In both cases, the interest rates are rounded off to the nearest full percentage. The rates will be adjusted quarterly, with the rate determined during the first month of the calendar quarter and effective for the following calendar quarter.[271] This reduces the current three month lag between the date when the rate is determined and the date when it becomes effective to two months. The revision in calculation of interest rates was designed to prevent taxpayers from either overpaying to take advantage of an excessively high rate or delaying payment as long as possible to take advantage of an excessively low rate charge.[272] It also reflects Congress' feeling that the currently utilized interest rates are not sufficiently modeled on other interest rates in the general economy.[273]

The Service is also given authority to issue regulations to coordinate §6621 with §6601(f).[274] The latter section provides that no interest is imposed on that portion of a tax due which is satisfied by a credit of an overpayment. While the Service can net many offsetting underpayments and overpayments, Congress felt it necessary to give it a transitional period during which to coordinate the two sections. The regulations will provide for the netting of such payments through a period ending three years after the enactment of the law, by which time the Service is expected to have computerized netting procedures.[275]

These provisions are effective for purposes of determining interest for periods after December 31, 1986.[276]

Note: Rev. Rul. 86-146 established the rate on overpayments at 8% and the rate on underpayments at 9% for the quarter beginning January 1, 1987.

Act §1511 provides 18 technical amendments which clarify that certain transactions calculated in terms of a single interest rate are defined in terms of the interest rate on underpayments.[277] For example, the interest on the failure to surrender property which is subject to a Service levy is defined in terms of the interest rate on underpayments only.[278] For certain other transactions, the interest rate is defined in terms of the interest rate on overpayments, rather than the single interest rate under pre-TRA law.[279] For example, the interest rate on the return of monies wrongfully levied upon by the Service (where the monies are returned to the taxpayer) is defined in terms of the interest rate on overpayments.[280] These technical amendments apply for purposes of determining interest for periods after December 31, 1986.[281]

2. Interest on Accumulated Earnings Tax

The 1986 Act provides that interest is imposed on underpayments of the accumulated earnings tax from the due date (without regard to extensions) of the income tax return for the year the tax is initially imposed.[282] By imposing interest from the date the return was originally

---

[265] Code §6621(d)(1).
[266] *See* Rev. Rul. 86-59, 1986-1 C.B. 364.
[267] *Forseth v. Comr.*, T.C. Memo 1985-279. *See also DeMartino v. Comr.*, T.C. Memo 1986-243.
[268] *Id.*
[269] Code §6621(a)(1), as amended by Act §1511(a) and Code §6611(a), as amended by Act §1511(c)(13).
[270] Code §6621(a)(2), as amended by Act §1511(a) and Code §6601(a), as amended by Act §1511(c)(11).
[271] Code §6621(b)(1) and (2), as amended by Act §1511(a).
[272] House Report at 849-850.
[273] *See* Senate Report at 184.
[274] Act §1511(b).
[275] *See* Senate Report at 185.
[276] Act §1511(d).
[277] Act §1511(c)(1) - (9),(c)(11)-(15), (c)(17) and (18).
[278] *See* Code §6332(c)(1), as amended by Act §1511(c)(9).
[279] *See* Act §1511(c)(10) and (16).
[280] Code §6343(c), as amended by Act §1511(c)(10).
[281] Act §1511(d).
[282] Code §6601(b)(4), as added by Act §1512(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

due to be filed, Congress is attempting to equalize the treatment of interest in this area with that in the rest of the Code.[283]

This amendment applies to returns the due date for which (without regard to extensions) is after December 31, 1985.[284]

D. Authority to Abate Interest

The 1986 TRA gives the Service authority and discretion to abate the interest attributable to the delay caused by a Service official or employee who either fails to perform an administerial act in a timely manner or makes an error in performing a ministerial act.[285] However, the abatement will only be available if no significant aspect of such error or delay can be attributed to the taxpayer involved and after the Service has contacted the taxpayer in writing concerning the deficiency or payment.[286] Abatement would not be available for the period of time between the date a taxpayer files a return and the date the Service commences an audit (regardless of the length of time). Moreover, abatement would also not be available if the taxpayer filed a return but did not pay the taxes, regardless of how long it took the Service to contact him and request payment.[287]

The House Report indicates that the type of ministerial acts which the measure is aimed at include both issuing a statutory notice of deficiency and a notice and demand for payment after all procedural and substantive preliminaries have been completed.[288] A ministerial act is thus a procedural action rather than a decision in a substantive area of tax law and is limited to nondiscretionary acts where all of the preliminary prerequisites (such as conferencing and review by supervisors) have taken place.[289] The House Report gives as an example of grounds for abatement, an unreasonable delay in the issuance of a statutory notice of deficiency after the Service and the taxpayer have already completed their efforts to resolve the matter.[290]

The Senate Report states that the Service may define a ministerial act in regulations, as well as issuing regulations (under its general authority to do so) which determine what constitutes timely performance of various ministerial acts performed by the Service.[291] Although this regulatory authority is not discussed in the conference report, the conference agreement adopted the Senate version of the tax reform legislation and the Senate language therefore presumably can be implemented by the Service.

The law also mandates that the Service abate the assessment of all interest on any erroneous refund under §6602 until the date demand for repayment is made.[292] However, this abatement power is not available if the taxpayer or a related party has in any way caused the erroneous refund or the erroneous refund exceeds $50,000.[293] Once the Service has requested repayment and the taxpayer does not pay, interest would then begin to apply to the amount of the erroneous refund.[294]

The authority to abate interest attributable to errors and delays by the Service applies to interest accruing with respect to deficiencies or payments for taxable years beginning after December 31, 1978.[295] A special statute of limitations rule provides that if the refund or credit of any amount resulting from this amendment is prevented through operation of any law or rule of law (including *res judicata*) at any time before the close of the date which is one year after the date of enactment (*i.e.*, after October 22, 1986), the refund or credit (to the extent attributable to the amendment) may still be made or allowed, but only if the claim for it is filed before the close of the one year period.[296]

E. Suspension of Compounding Where Interest on Deficiency is Suspended

The 1986 Act provides that, in cases where a waiver on the restrictions on assessment of a deficiency (on income, estate, gift and certain excise taxes) is filed after the the Service and the taxpayer have agreed on the tax, the compounding of interest will be suspended from the thirty-first day after the waiver is filed until the date when notice and demand are issued by the Service.[297] This corrects a mechanical problem which suspended the imposition of interest but did not suspend the compounding of interest on amounts which had previously accrued on the underlying deficiency. Since the law is made effective for interest accruing in taxable periods after December 31, 1982,[298] but the Service does not have the data processing capacity to unilaterally suspend compounding on the subject interest, the conference report suggests that affected taxpayers apply for refunds and, in appropriate cases, have the Service perform the required computations to suspend the compounding.[299]

However, if a credit or refund resulting from an application of this amendment is prevented at any time before the close of the date which is one year after the date of enactment (*i.e.*, October 22, 1986) by the operation of any law or rule of law (including *res judicata*), refund or credit may be made (to the extent of the amount attributable to the application of the amendment) or allowed if the claim is filed before October 23, 1987 (the close of the one year period).[300]

F. Clarification of "Tax Motivated Transactions" for Interest Purposes

The redesignated §6621(d), dealing with the interest on substantial underpayments attributable to tax motivated

[283] *See, e.g.*, Senate Report at 185-186.
[284] Act §1512(b).
[285] Code §6404(e)(1), added by Act §1563(a).
[286] *Id. See also* Conference Report at II-811.
[287] *Id.*
[288] House Report at 844.
[289] *Id.* at 845.
[290] *Id.*
[291] *See* Senate Report at 209.
[292] Code §6404(e)(2), as added by Act §1563(a).
[293] The abatement power would not have applied to erroneous refund checks exceeding $1 million under the Senate version of the bill. *See* Senate Report at 208-209.
[294] Conference Report at II-811.
[295] Act §1563(b)(1).
[296] Act §1563(b)(2).
[297] Code §6601(c), as amended by Act §1564(a).
[298] Act §1564(b)(1).
[299] Conference Report at II-812.
[300] Act §1564(b)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

transactions is amended by the 1986 Act to include "any sham or fraudulent transaction" in the meaning of "tax motivated transactions."[301] The intent of the conferees in making this change was to be consistent with the legislative intent of the original idea behind §6621(d) and to overrule the *Forseth* and *DeMartino* decisions,[302] which the conferees viewed as anomalous. Thus, the conferees sought to specifically overrule these cases through these provisions. The clarification of the inclusion of sham and fraudulent transactions in this provision is made retroactive by applying it to interest accruing after December 31, 1984, except in the case of any underpayment if there was a final court decision before the date of enactment of the 1986 Act.[303]

V. Fringe Benefit Plan Information Returns

A. Introduction — Pre-1986 TRA Law

Under Code §6039D, every employer which maintains a "specified fringe benefit plan" must file an information return for any portion of a year in which an "applicable exclusion" applies.[304] For this purpose, a "specified fringe benefit plan" is any qualified group legal services plan,[305] any cafeteria plan,[306] and any educational assistance program.[307] An "applicable exclusion" occurs when, under the respective Code sections, the taxpayer-employee has excluded a benefit from gross income. The return filed must show the number of total employees, those eligible to participate and actually participating in the plan, the total cost of the plan during the year and other identifying information concerning the employer.[308]

B. Detailed Analysis

In a technical correction, the 1986 Act repeals §6039D as added by P.L. 98-612 (which extended for one year the exclusion from gross income of certain fringe benefits) and §6039D as added by P.L. 98-611 (an Act relating to the Educational Assistance Programs) as amended.[309] The effect of the amendment is to integrate the definition section of §6039D as enacted in each Act (the Acts being enacted on the same day) so that the term "specified fringe benefit plan" and "applicable exclusion" for purposes of certain fringe benefit plan returns includes (1) qualified legal services plans, (2) any cafeteria plans, and (3) any educational assistance plans. This amendment is effective as if included in the provision of the Tax Reform Act of 1984 to which it relates.[310]

A different section of the 1986 Act further amends the fringe benefit reporting requirements by expanding the definition of "specified fringe benefit plan" and correlating the definition of "applicable exclusion" to the new definition. Thus, in addition to the pre-1986 TRA restated definition discussed above, the term "specified fringe benefit plans" includes a group term life insurance plan,[311] an accident or health plan,[312] and a dependent care assistance program.[313] The term "applicable exclusion" is defined as the specific Code section of the newly redefined "specified fringe benefit plan" under which benefits under a specific type of plan are excludable from gross income.[314]

The information return filed under these rules must also show the number of highly compensated employees who are listed in three categories of information: (1) the number of employees, (2) those employees eligible to participate, and (3) those employees actually participating.[315] In addition, the requirement for additional information returns under §6039D is relaxed to a certain extent by permitting the Treasury to require such returns only from a representative group of employers.[316] The revised requirements are effective generally, as with the nondiscrimination and other rules for statutory employee benefit plans, for plan years beginning after after January 1, 1987.

---

[301] Code §6621(c)(3) [as redesignated from §6621(d)(3) of prior law] (A)(v), added by Act §1535(a).
[302] *See* Conference Report at II-796.
[303] Act §1535(b).
[304] Code §6039D(a).
[305] Defined in Code §6120.
[306] Defined in Code §6125.
[307] Defined in Code §127.
[308] *See* Code §6039D(a)(1)-(5).
[309] Act §1879(d)(1) and (2).
[310] Act §1881.
[311] Defined under §79.
[312] Available under Code §§105 or 106.
[313] Available under Code §129. All three are added in Code §6039D(d)(1), as amended by Act §1151(h)(1).
[314] Code §6039D(d)(2), as amended by Act §1151(h)(1).
[315] Code §6039D(a)(6), as added by Act §1151(h)(2).
[316] *See* Act §1151(h)(3). *Note*: This provision erroneously refers to Code §6039B, but is obviously intended to refer to §6039D. Code §6039B was repealed by Act §1303(b)(5).

Chapter 45

REVISED ESTIMATED TAX REQUIREMENTS

Lucia N. Smeal, Esq.
Andrew E. Huddleston, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

Individual taxpayers who receive salaries and wages are generally subject to withholding for federal income taxes.[1] Taxpayers who are self-employed or otherwise not subject to withholding must make quarterly payments on their estimated tax liability. These payments must in total equal 100% of the previous year's tax liability or 80% of the current year's liability, whichever is lower. The payments are due by April 15, June 15, September 15 of each year and January 15 of the following year.[2]

When a taxpayer fails to make estimated tax payments, he or she is subject to a penalty. Any amounts withheld by an employer from wages or salary are considered to be estimated tax payments.[3]

Corporations must make estimated tax payments on their regular taxable income only;[4] no payment is required on the basis of a corporation's alternative minimum taxable income, although the corporation must pay that tax liability if it proves to be higher than its regular tax.

Trusts and estates are not required to make estimated tax payments. Trusts must pay their income taxes at the time they file their returns; estates are allowed to pay the entire liability in four quarterly installments beginning at the time the return is filed.

There are no estimated tax payments required of private foundation's for the excise taxes on net investment income nor on tax-exempt organizations for unrelated trade or business income.

II. Overview

The Tax Reform Act of 1986 makes several changes to the estimated tax payment requirements and penalty provisions. The measure of estimated tax payments is increased from 80% to 90% of the current year's tax liability.[5] Corporations now will have to make estimated tax payments on their alternative minimum taxable income.[6] Also, liability for estimated taxes is extended to trusts and estates,[7] to private foundations for excise taxes on net investment income, and to tax-exempt organizations for unrelated business income tax.[8] Finally, the Act waives estimated tax penalties for underpayments of tax attributable to retroactive changes made by TRA 1984 and TRA 1986.[9]

III. Detailed Analysis

A. Current Liability Test

The required total for each year's estimated tax payments is increased from 80% to 90% of a taxpayer's current year tax liability under §1541 of TRA 1986. Thus, individual taxpayers must make estimated tax payments for the year equal to the lesser of 100% of the previous year's tax liability or 90% of the current year's tax liability to avoid the §6654 penalty. These changes are effective for taxable years beginning after December 31, 1986. However, the increased percentage for computing estimated taxes does not apply to the estimated tax payment due January 15, 1987, because it is the final payment for taxable year 1986.[10]

To conform with the change in the current liability test, the Act sets the applicable percentages for determining annualized income installments under Code §6654(d)(2) at 22.5% for the first installment, 45% for the second installment, 67.5% for the third installment, and 90% for the fourth installment.[11] The alternative annualizing rule permits taxpayers to pay estimated tax installments based on the "applicable percentage" of tax computed by placing on an annualized basis the taxpayer's taxable income, alternative minimum taxable income, and adjusted self-employment income for the months in the current tax year ending before the installment due date. Finally, the Act revises the applicable percentages for payment of estimated taxes in three installments by nonresident aliens not subject to

[1] §§3401-3404.
[2] §6654.
[3] §6654(a) and (g).
[4] §6655.
[5] Act §1541.
[6] Act §701(d).
[7] Act §1404.
[8] Act §1542.
[9] Act §§1543, 1879(a).
[10] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-797 (1986) (hereinafter referred to as "Conference Report").
[11] Act §1541(b)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

withholding on wages, again to reflect the change from 80% to 90% in the current liability test.[12]

B. Estates and Trusts

The Tax Reform Act of 1986 requires estates and trusts to pay estimated income taxes in the same manner as individual taxpayers. This change, contained in Act §1404, is effective for taxable years beginning after December 31, 1986. In conjunction with the extension of the estimated tax rule to estates, the Act repeals §6152, which permitted estates to pay their income tax in four quarterly installments after the year in which it was earned. However, estates are exempt from having to pay estimated taxes for their first two taxable years. In addition, §643 is amended to permit trusts to elect to assign any amount of their estimated tax payments to their beneficiaries. This election is made on the trust's tax return, which must be filed within 65 days after the end of the trust's taxable year. The beneficiary is deemed to have received a distribution on the last day of the electing trust's taxable year for Federal income tax purposes, and, under the statute, the payment will be treated as having been made by the beneficiary on January 15 following the end of the trust's taxable year. However, in contradiction of the Act, the conference report states that, for purposes of the beneficiary's estimated tax liability, credit for the payment is treated as being received on the date the election is made by the trustee.[13] Also, a trust's estimated tax payments may be credited to a beneficiary only to the extent that they exceed the amount of income tax which the trust shows on its own return for the same taxable year.[14]

C. Corporate Minimum Tax

Under revised §6154(c)(1), corporations now will have to make estimated tax payments on their alternative minimum taxable income. This change was added by Act §701(d) and is effective for taxable years beginning after December 31, 1986.

Observation: This provision is likely to have problematic and costly effects in view of the revision of the alternative minimum tax for corporations. Through the introduction of the book income preference as an element of the minimum tax, Congress has ensured that many corporations will actually be taxed under this regime rather than under the regular corporate tax. Calculating the book income preference will require determining business untaxed reported profits, which in turn is based on financial statement income as adjusted to be on a comparable basis as taxable income.[15] Calculation of book or financial income presents considerable uncertainty, compounded by the authority which Congress has given to the Treasury to deal with omissions or duplications of items in the application of the book income preference.[16] Determination of estimated tax payments on the ultimate amount of tax under this system may prove extremely difficult for many corporations, with substantial penalties for those which err in projecting too conservatively.

D. Tax-Exempt Organizations

Section 6154 is amended by TRA 1986 to extend liability for estimated taxes to private foundations for excise taxes on net investment income [17] and to tax-exempt organizations for unrelated business income tax.[18] Act §1542 requires that these entities pay estimated taxes in four quarterly installments, in the same manner as is currently required of corporations, for taxable years beginning after December 31, 1986.

It is interesting to note that neither provision originated in either the House or Senate Committee versions of the Act and little discussion of the change is found in the Conference Report.[19] The estimated tax requirement for tax-exempt organizations with unrelated trade or business income was included to pay for a special transition rule sponsored by Massachusetts Senators Kerry and Kennedy to offset the cost of continued tax-exemption for a specific public housing project.[20] The parallel change for private foundations with net investment income was offered in a floor amendment by Senator Matsunaga of Hawaii to provide revenue to allow convention and trade-show educational activities to be excluded from the definition of unrelated trade or business.[21]

E. Waiver of Penalties for TRA 1984 and TRA 1986 Changes

The Act waives estimated tax penalties imposed by §§6654 and 6655 for underpayments of tax attributable to retroactive changes made by TRA 1984 and TRA 1986. For TRA 1984, Act §1879(a) waives estimated tax penalties for any period before April 16, 1985 (March 16, 1985 for corporations subject to Code §6655) for underpayments created or increased by TRA 1984. For TRA 1986, Act §1543 waives estimated tax penalties for any period before April 16, 1987 (March 16, 1987 for corporations subject to §6655) for underpayments created or increased by TRA 1986. Thus, with respect to TRA 1986 changes, taxpayers have until these dates to pay their full 1986 tax liability without incurring any additions to tax.

Note: Although the statute deals specifically with abatement of penalities for underpayments due to changes introduced by the Act, the conference report details a different, contradictory rule for underpayments of tax by corporations attributable to expected 1986 investment tax credits. (The regular investment tax credit is repealed for property placed in service after 1985 by Act §211.) It states

[12] Act §1541(b)(3). Note that Section 1841 of the technical corrections portion of TRA 1986 restores the §6654(j) provision permitting nonresident aliens to pay their estimated tax liability in three, rather than four, installments. This change is discussed in III, F, *infra*.

[13] Conference Report at II-766.

[14] §643(g)(1).

[15] *See* Chapter 33 for an explanation of the calculation of the book income preference.

[16] Conference Report at II-273-4.

[17] Imposed by §4940.

[18] Imposed by §511.

[19] Conference Report at II-798.

[20] *See* Amendment No. 2165 to H.R. 3838, 132 Cong. Rec. S8223 (daily ed. June 24, 1986).

[21] *See* Matsunaga Amendment, 132 Cong. Rec. S8078 (daily ed. June 20, 1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

that the §6655 penalties only will be waived for corporate taxpayers to the extent that: (1) the underpayment of an installment results from a corporation taking into account investment tax credits on property placed in service after December 31, 1985 but before the date of enactment of the Act; and (2) the corporation actually pays the underpayment within 30 days of the enactment of the Act.[22] This rule would have applied to investment tax credits for property placed in service after December 31, 1985.

The IRS responded to this conflict by issuing Rev. Rul. 86-136 1986-48 I.R.B. 9, in which it announces that it will ignore the conference report as being in error and observe the rule contained in the statute. The ruling goes on, however, to note that the dates for correcting underpayments are final. They will not be modified either by extensions that a taxpayer may obtain for filing his return or for taxpayers who do not use the calendar year as their taxable years. Also, the ruling notes, the Act provides no relief from interest on underpayments of estimated tax. Interest will continue to be assessed on underpaid tax liabilities before April 15 (or March 15) 1986, even though no penalty is charged.

[22] Conference Report at II-64.

F. Nonresident Aliens — TRA 1984 Correction

Section 1841 of the technical corrections portion of TRA 1986 restores a provision permitting nonresident aliens to pay their estimated tax liability in three, rather than four, installments. Under §6073 before its repeal by the Tax Reform Act of 1984, nonresident aliens (other than those whose wages are subject to withholding under §3402) were not required to make their first installment payment of estimated tax until June 15 (the 15th day of the sixth month) of the taxable year. This provision was inadvertently deleted by TRA 1984.[23] To correct this error, the final bill adds new §6654(j), which permits nonresident aliens to pay their estimated tax liability in three installments on June 15, September 15, and January 15 of the following taxable year (or the 15th day of the sixth, ninth, and first month in the case of a fiscal year taxpayer). Fifty percent of the annual payment is due on the first installment. In addition, the Act sets the applicable percentages for determining annualized income installments at 45% for the first installment, 67.5% for the second installment, and 90% for the third installment.

[23] *See* §412 of P.L. 98-369 and General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, prepared by the Staff of the Joint Committee on Taxation, at 709 footnote 3; *cf* Internal Revenue Service Announcement 85-63, 1985-17 I.R.B. 21.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 46

CHANGES AFFECTING ADMINISTRATIVE AND JUDICIAL PROCEDURES

Steven C. Wallace, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

The 1986 TRA enacts three provisions designed to enhance administrative and judicial efficiency. In the administrative arena, the Internal Revenue Service (IRS) is provided with discretion to rescind a notice of deficiency after issuance. In the area of Tax Court procedure, the Tax Court is provided with the power to assess a damages penalty of up to $5,000 if a taxpayer fails to exhaust administrative remedies before filing a Tax Court petition. Additionally, the Tax Court has been given the discretion to certify for appellate review a Tax Court interlocutory order before a full decision is issued. These and other administrative and judicial provisions enacted or amended by the 1986 TRA are discussed below.

II. Analysis of Provisions

A. Suspension of Limitations if Third Party Records Not Produced

In general, the Code provides a three-year statute of limitations for the assessment of a tax deficiency.§6501. In cases of fraud, willful tax evasion, or a failure to file, however, there is no limitations period. Also, an exception is provided in the case of a sizable understatement of income, in which event a six-year limitations period applies.[1] The three-year statute of limitations also applies to most criminal prosecutions. A six-year statute of limitation, however, applies in instances of fraud, attempted fraud and willful evasion of payment, among other offenses.[2]

Before the the 1986 TRA, these statutes would continue to run if the IRS sought records held by third parties. The statutes were suspended if the taxpayer intervened to attempt to quash the IRS summons for the records held by the third-party recordkeeper.[3] If the taxpayer did not intervene, but the IRS nevertheless had to bring an action against the third-party recordkeeper to compel production of its records, the statute of limitations could expire before final determination as to the availability of the records.

The 1986 TRA amends §7609 to provide that if a dispute between the third-party recordkeeper and the IRS is not resolved within six months after the IRS issues an administrative summons, the statute of limitations is tolled until the issue is resolved.[4] The suspension applies both to the limitations period on assessing deficiencies and to the limitations period on commencing criminal prosecutions. The third-party recordkeeper is required to provide notice of the suspension of the running of the statute to the taxpayer whose records are the subject of the dispute, if the summons requesting the records does not identify the taxpayer by name.[5] Failure by the third-party to do so does not, however, prevent the suspension of the statute.[6] As under pre-1986 TRA law, the statute of limitations continues to be suspended during the period when a taxpayer intervenes in the dispute between the IRS and a third-party recordkeeper. The statute is suspended from that date until the entire dispute is resolved. Senate Report at 207.

The amendment of §7609(c) relating to the suspension of the statute during a third-party recordkeeper dispute is effective on the date of enactment of the 1986 TRA, October 22, 1986. Act §1561(c).

B. Authority to Rescind Notice of Deficiency

Under pre-1986 TRA law, once the IRS had issued a statutory notice of deficiency (90-day letter), it did not have the authority to withdraw the letter. The notice had to be issued before the expiration of the statute of limitations as the notice was a condition precedent to the assessment by the IRS of a tax deficiency. Under §6213, the IRS may not assess an income tax deficiency until at least 90 days after the notice has been sent to the taxpayer (150 days if the notice is addressed outside the U.S.). Moreover, during this 90 (or 150) day period, the taxpayer may file a Tax Court petition, and, if such petition is filed, the assessment of the deficiency is barred until the Tax Court's decision is made final. A notice of deficiency is not valid unless issued before the expiration of the statute of limitations. Once the notice is issued, only a Tax Court decision can alter its effect.

Under §6501(c)(4) the IRS and taxpayer may mutually consent in writing to extend the statute. The IRS customarily seeks a mutual consent to extend when it determines that the statute will expire before it will complete its examination of a taxpayer's return or before IRS action at the appellate level is completed. Generally, a taxpayer will agree to the extension because the IRS otherwise will issue a protective notice of deficiency for the maximum possible deficiency. From the taxpayer's stand-

[1] §6501(c).
[2] §6531.
[3] §7609(e).
[4] Act §1561.
[5] S. Rep. No. 313, 99th Cong., 2d Sess. p. 206-07 (1986) ("Senate Report").
[6] Senate Report at 207.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

point, a notice of deficiency is presumed to be correct, and the taxpayer will have the burden of introducing sufficient proof to overcome the presumption. If the taxpayer believes that further investigation by the IRS will reduce or eliminate a potential deficiency, it is obviously in the taxpayer's interest to consent to the extension. However, not infrequently a protective notice will be issued even if the taxpayer is willing to consent to an extension because of a lack of, or breakdown in, communication between the taxpayer and the IRS.

Consequently, before the 1986 TRA, a protective notice of deficiency could remain outstanding even though neither the taxpayer nor the IRS was fully prepared to contest a deficiency in Tax Court. In light of such a situation and similar situations where the taxpayer and IRS would prefer to dispose of a case administratively, the 1986 TRA,[7] amends §6212 to allow the withdrawal of a statutory notice where the IRS and the taxpayer mutually agree. Once properly rescinded, the notice is treated as if it never existed. Therefore, limitations regarding credits, refunds, and assessments relating to the rescinded notice are void, and the parties are returned to the rights and obligations existing prior to the issuance of the withdrawn notice.[8] Also, the IRS may issue a later notice for a deficiency greater or less than the amount of the rescinded notice.[9] This withdrawal procedure is effective for statutory notices of deficiency issued on or after January 1, 1986. Act §1562(b).

Specific application of the withdrawal procedure is unclear. Code §7805, empowers the Secretary to establish by regulation the procedures necessary to implement the new withdrawal of notice provision to assure that the taxpayer has consented to the withdrawal of the statutory notice. The regulations should also clarify the effect of rescission and other provisions of the Code. Presumably, the regulations will condition IRS consent to the withdrawal of the notice of deficiency upon the taxpayer's willingness to extend the statute of limitations for deficiencies, since it is unlikely that the IRS would jeopardize its opportunity to reissue a deficiency notice. The legislative history is silent as to the details of the forthcoming regulations.

Whether a notice can be rescinded once the taxpayer has filed a Tax Court petition is an open question although there is no apparent statutory bar to a withdrawal in such instance. Presumably, the Tax Court's dismissal of the petition without prejudice would be required. The possibility also exists that the IRS might agree to rescind a notice of deficiency even after the 90 (or 150) day period for filing a petition, as set forth in the notice of deficiency, expired.

C. Penalty for Failure to Pursue Administrative Remedies

Under the pre-1986 TRA Law, §6213(a), taxpayers dissatisfied with deficiencies proposed by the IRS on audit could take their case to the Tax Court without resorting to the IRS's administrative appeals procedure. No penalty would be incurred for a failure to exhaust administrative remedies. A potential disadvantage of such failure might be a denial of an attorney's fee award under §7430 if the taxpayer "substantially prevailed" in court and showed that the IRS's position in the proceeding was unreasonable. Section 7430(b)(2) provides that a court shall not award reasonable litigation costs under §7430(b) in any civil tax proceeding unless the court determines that the prevailing party has exhausted the administrative remedies available within the IRS. Regs. §301.7430-1 details the factors that the IRS normally will consider in determining whether such administrative remedies have been exhausted by the taxpayer.

The decision whether to exhaust administrative remedies or proceed directly to court was often determined solely by economic considerations. In order to receive consideration at the IRS's appeals level, a written protest detailing the facts and the authorities on which the taxpayer is relying is ordinarily required. The written protest might run for 10 to 50 pages and entail a considerable expenditure of a practitioner's time and corresponding expenditure of the client taxpayer's funds. The protest is generally followed by a conference between an IRS appeals officer and practitioner. A Tax Court petition, in contrast, may be as short as two to five pages setting forth a mere outline of facts. Moreover, it is the IRS's standard practice in a Tax Court action to refer the case to its appeals office for initial negotiation of a settlement. Thus, the Tax Court petition route may provide the same administrative review as the protest route but at a considerably lower cost. As previously mentioned, the sole detriment of filing the petition is the potential loss of an attorney's fee award for failure to exhaust administrative remedies.

The 1986 TRA adds a penalty provision for failure to pursue administrative remedies that will significantly alter the foregoing economic equation. The 1986 TRA,[10] amends §6673 to provide that unreasonable failure by a taxpayer to exhaust administrative remedies is an additional basis that the Tax Court may consider in imposing up to $5,000 in damages against the taxpayer under §6673. Before the 1986 TRA amendment, §6673 gave the Tax Court discretionary authority to award up to $5,000 in damages to the United States where the taxpayer institutes or maintains proceedings primarily for delay or advances frivolous or groundless positions. With the addition of the failure to exhaust remedies ground as an additional basis for §6673 damages, the written protest route may be selected as the more economical approach in more cases.

The addition of a penalty provision for failure to exhaust administrative remedies had its genesis in the House Bill.[11] Under the House Bill, a nominal $120 penalty would have been imposed for such failure. The penalty would apply where the taxpayer did not exercise "reasonable efforts in good faith" to resolve a case administratively. The House Report listed five situations in which the taxpayer

[7] Act §1562.
[8] H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-810 (1986) ("Conference Report").
[9] Conference Report, p. II-810, Act §1562.
[10] Act §1552.
[11] H.R. 3838 as passed by the House, §1316, adding §6710 to the Code, p. 1005-1006.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

would be considered to have satisfied the "reasonable efforts" standard, as follows:[12]

(i) The taxpayer is only challenging an existing ruling or regulation or similar matter that an appeals officer is not authorized to negotiate;

(ii) The taxpayer has attended one first-level Appeals meeting;

(iii) The taxpayer cannot attend a first-level meeting because it would be unduly burdensome;

(iv) The IRS has waived the Appeals meeting; or

(v) The case has been pending before Appeals for six month without action.

The Conference Committee struck the House penalty and substituted the §6673 damages amendment. No reason was given for this action but it presumably represents a recognition that the House $120 penalty would have an insignificant impact. The Conference Report [13] does not say whether the five factors listed in the House Report would also apply in considering §6673 damages.

Regs. §301.7430-1 details standards for determining whether a taxpayer exhausted administrative remedies for purposes of recovering reasonable litigation costs in civil tax proceedings. It is unclear whether this regulation will provide the blueprint to the Tax Court in assessing §6673 damages. It should be noted, however, that the examples in the regulation take a more restrictive approach on exhaustion than do the examples set forth in the House Committee Report.

Note: The 1986 TRA states that the amendment to §6673 applies to proceedings commenced after the date of enactment, October 22, 1986. Act §1552(b). Presumably, "proceedings" refers to Tax Court proceedings, which are initiated by the filing of a petition. This effective date may work some inequity since the only notice that a penalty might be exacted for failing to pursue remedies was the $120 House passed penalty. Even assuming awareness of the penalty, it is unlikely a taxpayer's decision to forego appeals would have been swayed by the proposed $120 change. The $5,000 damages provision, on the other hand, might have had an impact, but this change was made in Conference. By that time, the taxpayer may have bypassed appeals and been irrevocably committed to filing the petition because of receipt of a notice of deficiency.

D. Jurisdiction Over Failure to File Penalty

Before the 1986 Tax Act, the Tax Court held that it did not have jurisdiction over any addition to tax for failure to pay the amount of tax shown on the taxpayer's return, even though it has jurisdiction to redetermine a deficiency in tax with respect to that return.[14]

The 1986 TRA,[15] amends §6214 by giving the Tax Court jurisdiction over an addition to tax for failure to pay an amount shown on the return in cases where the Tax Court already has jurisdiction to redetermine a deficiency in tax with respect to that return. This amendment does not otherwise alter the jurisdiction of the Tax Court. It also does not affect §6651(a)(1), the late filing addition to tax or the procedure for assessing additions to tax under §6662(b). *See* Conf. Report, p. II-804.

This change is effective for any action or proceeding before the Tax Court which has not become final before the date of enactment, October 22, 1986. Act §1554(b).

E. Appeals from Tax Court Interlocutory Orders

To date, the Second Circuit has held that the U.S. Court of Appeals does not have any jurisdiction over any interlocutory order issued by the Tax Court.[16]

The 1986 TRA,[17] amends §7482 to provide for appeals of Tax Court interlocutory orders where the Tax Court judge certifies: (1) that a controlling question of law is involved with respect to which there is a substantial ground for difference of opinion and (2) that an immediate appeal from that order may materially advance the ultimate termination of that litigation. Application of appeal must be made within 10 days after entry of an interlocutory order and, at that time, the U.S. Court of Appeals may exercise its discretion to grant the appeal. Tax Court proceedings are stayed only in the event that the Tax Court judge or the U.S. Court of Appeals authorizes a stay in proceedings. This provision applies to Tax Court orders entered after the date of enactment (*i.e.*, October 22, 1986). Act §1558(c).

F. Limits on Award of Court Costs and Fees

Before the 1986 TRA, the maximum amount of reasonable litigation costs which could be awarded to a prevailing party in any civil tax proceeding was limited to $25,000.[18] Moreover, §7430(f) provided that the authority to award litigation costs terminated as to actions commenced after December 31, 1985. Act §1551 makes §7430 permanent and amends it to more closely conform to the provisions of the Equal Access to Justice Act (28 U.S.C. §2412).[19]

Act §1551(a) removes the $25,000 limitation, but Act §1551(c) redefines the term "reasonable litigation costs" in §7430(c) to provide in part that: (1) reasonable attorney's fees may not exceed $75 per hour unless the court determines that an increase in the cost of living or a special factor, such as the limited availability of qualified attorneys for such a proceeding, justifies a higher rate; (2) no expert witness may be compensated at a rate in excess of the highest rate of compensation for expert witnesses paid by the U.S. government.

Act §1551(b) adds a paragraph (4) to §7430(b) to prohibit an award for reasonable litigation costs for any portion of the proceedings during which the prevailing party is found to have unreasonably protracted the proceedings.

Act §1551(d) modifies the definition of "prevailing party" in §7430(c)(2) in two respects. First, under revised §7430(c)(2)(A)(i) it must be established that the position

[12] H.R. Rep. No. 426, 99th Cong., 1st Sess., p. 841-42 (1985).
[13] Conference Report, p. II-802-803.
[14] *Young Est. v. Comr.*, 81 T.C. 879 (1983).
[15] Act §1554.
[16] *Shapiro v. Comr.*, 632 F.2d 170 (2d Cir. 1980).
[17] Act §1558.
[18] §7430.
[19] *See* Conference Report, pp. 798-802.

of the United States was "not substantially justified," rather than "unreasonable," as under the pre-1986 TRA version. Second, §7430(c)(2)(A)(iii) adds a requirement that the party seeking an award must satisfy the net worth limitations of 5 U.S.C. §504(b)(1)(B) (as in effect on October 22, 1986). The "substantially prevailed" requirement of §7430(c)(2)(A)(ii) is retained.

Act §1551(e) adds a paragraph (4) to §7430(c) to provide that the term "position of the United States" includes both the position taken by the government in the civil proceeding and any administrative (*i.e.*, prelitigation) action or inaction of IRS District Counsel.

Pursuant to Act §1551(h), the 1986 TRA amendments to §7430 apply to amounts paid after September 30, 1986, in civil actions or proceedings commenced after December 31, 1985. (Accordingly, awards of attorney's fees in cases commenced before January 1, 1986, are governed by §7430 as in effect before that date. *See* Conference Report, p. II-802.) Section 7430 is made permanent by the deletion of §7430(f). Moreover, the 1986 amendments apply to any case commenced after December 31, 1985, and finally disposed of before the date of the enactment of the 1986 Act (*i.e.*, October 22, 1986), except that in such cases the 30-day period for seeking an award is deemed to commence on the date of enactment, October 22, 1986.

G. Tax Court Practice Fee

Before the 1986 Tax Act, the Tax Court imposed a $25 application fee before admission to practice before the Tax Court. Tax Court Rule 200. No fee was imposed after the application fee had been paid.

The 1986 TRA,[20] adds §7475 which authorizes the Tax Court to impose a periodic registration fee on practitioners admitted to practice before it. The Tax Court is to establish the level of fee and the frequency of its collection, but the fee may not exceed $30 per year. These funds are available to the Tax Court to pay independent counsel engaged by the court to pursue disciplinary matters. This provision is effective January 1, 1987. Act §1553(c).

H. Modified Levy in Forfeiture Rules

Under pre-1986 TRA law, Code §6334 listed various payments, such as unemployment benefits, workmen's compensation, a minimum amount of ordinary wages, as well as certain pensions and annuities, that were exempt from levy. The IRS could not seize these payments to collect delinquent taxes by serving a levy on the payment source.

The 1986 TRA,[21] amended §6334 to provide that effective for amounts payable after December 31, 1986, the IRS is prohibited from levying any amount payable to an individual as a military service-connected disability benefit under specified provisions of Title 38 of the United States Code. The term "service-connected" means that the disability was incurred or aggravated in the line of duty in the act of military service. The exemption covers direct compensation payments, as well as other types of support payments for education and housing.

[20] Act §1553.
[21] Act §1565.

Before the 1986 Tax Act, Code §7325 stated that in cases where goods are seized as being subject to forfeiture, the Secretary had to comply with certain listing and notice procedures where the Secretary believed the appraised value of the seized good was $2,500 or less.

The TRA 1986,[22] increases the value of personal property subject to these listing and notice procedures. The listing and notice requirements now apply where the Secretary believes the appraised value of the goods is $100,000 or less. This amendment is effective on the date of enactment of the 1986 Act, October 22, 1986.

The TRA 1986,[23] amending Code §6323, also specifies that the forfeiture of property under local law seized by a law enforcement agency of State, county, or other local governmental subdivision shall relate back to the time of seizure, except to the extent that under local law the holder of an intervening claim or interest would have priority over of the interest of the State, county, or other local governmental subdivision in the property. This amendment is effective on the date of enactment of the 1986 Act, October 22, 1986.

The TRA 1986,[24] provides new procedures for tax sales of seized property where no person offers the minimum price. This amends Code §6335 which provided that where no person offers the minimum price, the property shall be declared to be purchased at such price for the U.S.

The TRA 1986,[25] provides that before the sale of the property seized by levy, the Secretary shall determine a minimum price for that property. In addition, the Secretary shall determine whether the purchase of such property by the U.S. at such a minimum price, would be in the best interests of the U.S. If no person bids the minimum price, the U.S. can purchase the property only if the Secretary has determined that the purchase would be in the best interest of the U.S. If the minimum price is exceeded, the sale goes to the highest bidder. If the Secretary determines that purchase of the seized property by the U.S. is not in the best interests of the United States and no person bids the minimum price, then the property shall be released to the owner and the expense of the levy and sale shall be added to the amount of tax for the collection of which the levy was made. This provision applies to properties seized after the date of the enactment of the Act (October 22, 1986) and to properties seized on or before such date which are held by the U.S. on such date.

Before the 1986 Tax Act, Code §7425, in general, provided that before federal tax liens could be extinguished, notice had to be given to the U.S government. Several cases held that forfeitures of land sales contracts were not subject to these notice requirements.[26] Notice provided the Government with the opportunity to redeem the property.

The TRA 1986,[27] provides that forfeitures of land sales contracts are subject to the notification requirements effec-

[22] Act §1566.
[23] Act §1569.
[24] Act §1570.
[25] Act §1570.
[26] *Runkel v. U.S.*, 527 F.2d 914 (9th Cir. 1977); *Brookbank v. Hubbard*, 712 F.2d 399 (9th Cir. 1983).
[27] Act §1572.

tive for forfeitures after the thirtieth day after the date of enactment. Thus, these cases are implicitly overturned as to this issue. The TRA 1986 provides the government with both notice and the opportunity to redeem the property. Thus, land sales contracts are placed on the same footing as most other transfers of real estate.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 47

INCOME TAXATION OF TRUSTS AND ESTATES

Lynn K. Pearle, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

Congress generally believed that the prior system for taxing trusts and estates allowed for substantial income tax avoidance and a lack of equity among taxpayers. Specifically, Congress felt that the use of trusts permitted tax abuse by the accumulation of income at the trust's separate bracket or by dispersion of income among multiple beneficiaries based on each beneficiary's relative tax bracket.

Although Congress believed that the tax benefits resulting from the ability to split income between a trust or estate and its beneficiaries should be eliminated or significantly reduced, it also felt that it would not be necessary to make significant structural changes in the taxation of trusts and estates.

The major thrust of the Act provisions is to reduce the income tax advantages of the use of trusts and estates. The provisions are aimed at eliminating income shifting between family members and income deferral through the use of overlapping fiscal years.

II. Overview

To eliminate the use of trusts and estates for income shifting purposes, the Act revises the tax rate schedule applicable to trusts and estates, eliminates the *Clifford* and spousal remainder trusts, requires that trusts adopt the calendar year as their taxable year, and makes other miscellaneous changes.

III. Rate Schedules for Trusts and Estates

The Act retains the pre-1986 TRA system of taxing trusts and estates but compresses the rates applicable to income accumulated in trusts and estates. The compressed rates will reduce the benefits of pre-1986 TRA law resulting from a "ride up the brackets" for trusts and estates as separate taxpayers.

Act §101 amends §§1(e) and (g), the tax tables applicable to trusts and estates. The new rates provide that accumulated income of both existing and newly created non-grantor trusts and estates will be taxed at the following rates in taxable years beginning after December 31, 1987:

Taxable income	*The tax is*
0 to $5,000	15% of taxable income
Over $5,000	$750, plus 28% of excess over $5,000

Example: An individual in the top 28% bracket transfers income-producing property to a complex trust. The trust produces $6,000 of income and pays a tax of $1,030. If the donor had retained the property he would have paid a tax of $1,680 on the income. The transfer to the trust saved him $650, which may not cover the cost of administering the trust. If the individual is subject to the 5% surcharge (*see* §1(g)), the savings would increase to $900.

Beginning in 1988, the benefit of the 15% bracket is phased out for trust and estate income over $13,000 (the "applicable dollar amount"). The phase-out is accomplished by increasing the income tax liability of such trusts and estates by 5% of the taxable income between $13,000 and $26,000. Thus, for trusts and estates with taxable income of $26,000 or more, the 28% rate in effect applies to all of the entity's taxable income rather than only to the amount of taxable income above $5,000. For taxable years after 1988, the applicable dollar amount will be adjusted for inflation. Act §101(a). Accordingly, the effective rate of the new brackets beginning after December 31, 1987 is as follows:

If taxable income is:	*The tax is:*
Not over $5,000	15% of taxable income
Over $5,000 but not over $13,000	$750, plus 28% of the excess over $5,000
Over $13,000 but not over $26,000	$2,990, plus 33% of the excess over $13,000
Over $26,000	$7,280, plus 28% of the excess over $26,000

Under new §1(h), a transitional rate structure for 1987 imposes the following income tax rates on estates and trusts:

If taxable income is:	*The tax is:*
Not over $500	11% of taxable income
Over $500 but not over $4,700	$55, plus 15% of the excess over $500

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Over $4,700 but not over $7,550	$685, plus 28% of the excess over $4,700
Over $7,550 but not over $15,150	$1,483, plus 35% of the excess over $7,550
Over $15,150	$4,143, plus 38.5% of the excess over $15,150

These rates will apply only to income accumulated in the trust or estate. Trusts which distribute income currently will not be affected by this change and the income from these trusts will continue to be taxed to the beneficiary at his marginal tax rate. However, under new §1(i), the so-called Kiddie Tax provision affecting the taxation of unearned income of a child, if the child is under age 14, a portion of the income will be taxed at the parents' top marginal rate. The amendments made by §1(i) apply to taxable years beginning after December 31, 1986.

By compressing the rate schedule for trusts, there will be minimal income tax incentives for creating a trust, unless income is distributed currently to a beneficiary who is age 14 or over. Even if there may be a temporary tax savings resulting from the use of trusts, the throwback rules continue to apply to recoup any tax rate savings realized. Moreover, the lowering of the individual rate schedules further decreases the incentive for income splitting between family members.

Income shifting still may be accomplished in a limited way. If a child is under age 14, such child's unearned income up to $500 will be tax-free and from $500 to $1,000 will be taxed at the child's marginal rate. After the child attains the age of 14, income shifting of unearned income in excess of $1,000 may accomplish a meaningful reduction in total family taxes. Thus, transfers to children over age 14, either through custodial accounts or trusts which distribute income currently still may be advantageous.

Other devices for income shifting may fit particular circumstances. It may be possible to employ children in a limited manner. The usefulness of the gift and leaseback arrangement continues, although the use of trusts and the "Kiddie Tax" in connection with this arrangement must be carefully considered. Single premium and other tax deferred insurance and annuity products may be effective means of shifting income.

IV. Grantor Trust Rules

The Act eliminates income splitting by use of a *Clifford* or spousal remainder trust. Act §1402(a) amends §673 by eliminating the pre-1986 TRA exception for a reversion to the grantor that occurred more than 10 years from the date of the transfer to the trust. Under revised §673(a), the grantor is treated as the owner of any portion of the trust in which he has a reversionary interest in either the principal or income therefrom, if the value of the reversion equals or exceeds 5% of the value of that portion of the trust when contributed. The possibility that an interest may return to the grantor or his spouse solely under intestacy law is to be ignored.[1] Moreover, if the trust's beneficiary is a lineal descendant of the grantor, and such person holds the entire present interest in any part of the trust, the grantor is not deemed to have retained a proscribed power or interest in the trust if this interest or power takes effect only after the death of a lineal descendant under the age of 21.[2] The 5% valuation of a reversionary interest is parallel to §2037 and will probably be applied in a similar manner, by using actuarial tables to value reversionary interests, etc.

Note: Based on the current Treasury tables, a trust would have to continue for 32 years for the value of the remainder interest to be less than 5%.

Conforming changes are made to §§674(b)(2), 676(b) and 677(a), which had referred to the pre-1986 TRA §673 "period" and now refer to a §673 "event."

Act §1401(a) adds new §672(e) under which the grantor is treated as holding any power or interest held by his spouse if the spouse is living with the grantor at the time of transfer. This amendment applies to transfers made after March 1, 1986. Act §1401(b). The status of a person holding a power or interest as a spouse of the grantor with whom the grantor is living is determined at the time of the transfer of the property to the trust. Sen. Rep. at 871. It is not clear how this provision will be applied if the grantor and the powerholder are subsequently divorced.

Because of these structural changes, income from *Clifford* and spousal remainder trusts (whether distributed or not) will be taxed to the grantor. This provision applies to transfers to trusts made after March 1, 1986 unless the trust was created pursuant to a binding property settlement on or before such date. Act §1401(c). *Clifford* or spousal remainder trusts created before March 1, 1986 will continue to be treated as non-grantor trusts, with the distributed income taxed to the beneficiary and not the grantor. However, if a pre-March 1, 1986 *Clifford* or spousal remainder trust distributes income to a beneficiary under the age of 14, a portion of the income will be taxed at the parents' top marginal rate. A grandfathered pre-March 1, 1986 trust should not receive any post-March 1, 1986 additions or the trust will be taxed in part as a non-grantor trust and in part as a grantor trust.

Amended §673 and new §672(e) will have implications beyond eliminating *Clifford* spousal remainder trusts. For example, amending §673 to eliminate the 10-year rule means that *inter vivos* charitable lead trusts may be treated as grantor trusts if the principal reverts to the grantor after the charitable term, even if the charitable term exceeds 10 years.

Moreover, under §674(c), a grantor's spouse may serve as co-trustee with a non-related non-subordinate party and the trust will be deemed an independent trust. However, under new §672(e) the grantor will be treated as holding the spouse's power, which would make the trust a grantor trust, notwithstanding the protection of §674(c).

The *Clifford* and spousal remainder trusts were often used as a method of income splitting for financing a child's education. Other methods are still available, such as joint

[1] S. Rep. No. 313, 99th Cong., 2d Sess., p. 871 (1986)("Sen. Rep.").
[2] §673(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

purchases, where the child purchases a 10-year term interest and the parent purchases the remainder. However, with lower individual rates, it is questionable whether income-shifting techniques which are more complicated than simple trust arrangements will be of great interest to clients.

V. Taxable Years of Trusts

Under new §645, added by Act §1403, both existing and newly created trusts must adopt a calendar year as their taxable year. This provision applies to all types of non-grantor trusts except tax-exempt and wholly charitable trusts described in §§501(a) and 4947(a)(1), respectively, and will be effective for taxable years beginning after December 31, 1986.

This change will eliminate what has been an important post-mortem estate planning tool, the deferral of income by the judicious selection of a trust's fiscal year. Under pre-1986 TRA law, a trust on a fiscal year ending January 31 could defer eleven months of a beneficiary's income.

Moreover, this change means that trusts and their beneficiaries both will be on a calendar year and will file a return on April 15. This change will increase the workload of tax preparers to prepare Forms 1041 and K-1 at a time they are preparing Forms 1040.

Thus, under the Act, every trust now on a fiscal year will have a short taxable period beginning in 1987 and ending December 31, 1987. Under Act §1403(c)(2), a beneficiary who has to include short-period income resulting from this change will be allowed a 4-year ratable spread of the income beginning with the first taxable year after 1986. Therefore, if the amount includible in the income of a beneficiary for the short year is $8,000, the beneficiary will include $2,000 of income in four successive tax years beginning in 1987. This rule applies to distributions of DNI of the trust but does not apply to any accumulation distributions occurring during the short taxable year.[3]

Although Congress recognized that the same possibilities of deferral are present in the case of estates, due to the short duration of an estate, no change was made with regard to an estate's fiscal year.[4] Thus, it may be beneficial to keep estates open as long as possible before funding testamentary trusts.

VI. Tax Payments

Act §1404 amends §6654 to require that new and existing estates (after their second taxable year) and all trusts pay estimated tax. Note that funded *inter vivos* trusts which are used as estate substitutes will not have the benefit of the two year exemption for estates. The estimated tax requirement is the same as required for individuals.

Under new §643(g), added by Act §1404(b), a trust which has made estimated payments in excess of its income tax liability may elect to assign such excess to its beneficiaries, by an election on the trust's tax return which is filed within 65 days after the end of the trust's taxable year. Such an allocation will allow the payment to be applied to the beneficiary's estimated tax payment due on January 15 of the following year. If the trustee makes such an election, the amount of credits assigned to beneficiaries is considered a distribution under the 65-day rule of §663.[5]

Thus, the beneficiary to whom credit is assigned is deemed to receive a distribution on the last day of the trust's year for federal income tax purposes. Nevertheless, the beneficiary will treat the credit as received on the date the election is made for purposes of the beneficiary's estimated taxes. Conf. Rep. at II-766. It is not clear whether the trustee must allocate the credit among multiple beneficiaries in proportion to the beneficiaries' respective shares of distributable net income.

The estimated tax provision applies to taxable years beginning after December 31, 1986. Act §1404(d). Trusts currently on a fiscal year will first be subject to the estimated tax requirement for the short period ending December 31, 1987, as mandated by the new §645.

Act §1404(c)(1) repeals §6152, the present rule permitting executors to pay an estate's income tax in four equal installments. This provision, while accelerating the payment of the tax, will ease the administrative burden on the executor. The repeal of the rule permitting estates to pay income tax in four equal installments applies for taxable years beginning after December 31, 1986.

VII. Multiple Trusts

The Tax Reform Act of 1984 added §643(e) which provided that two or more trusts will be treated as one trust under Treasury regulations if the trusts have substantially the same grantors and beneficiaries and a principal purpose of the trust is the avoidance of federal income tax. This rule applied to tax years beginning after March 1, 1984, regardless of when the trusts were created.

Act §1806(b) redesignates §643(e) as §643(f) and repeals the authorization for multiple trust regulations with respect to trusts which were irrevocable on March 1, 1984, except with respect to contributions to corpus made after March 1, 1984.

This provision protects preexisting multiple trusts from the aggregation rule of§643. Presumably, to the extent that new §643(f) does not apply, the prior law of *Stephenson Trust Co. v. Comr.*, 81 T.C. 283 (1983), which invalidated a portion of the regulations, is controlling.

VIII. Distributions in Kind

The Tax Reform Act of 1984 added §643(d) which provided that a trustee or executor can elect to treat a distribution of property as carrying out DNI only to the extent of the lesser of the property's basis or its fair market value at the time of distribution.

Act §1806(a) amends §643(d) and redesignates it as §643(e). Redesignated §643(e)(3)(B) requires that an election by an executor or trustee to recognize gain on property distributed in kind must apply to all property distributed by

[3] Sen. Rep. at p. 873.
[4] Sen. Rep. at p. 872.
[5] H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-766 (1986)("Conf. Rep.")

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the estate or trust during the taxable year to which the election applies, unless the election is revoked with the consent of the Secretary. This provision is retroactive to distributions made on or after June 2, 1984, the original effective date of redesignated §643(e).

This amendment eliminates the possibility of electing to recognize gain on an asset-by-asset basis. However, since the election may be made on a year-by-year basis, the executor or trustee still may group assets together for distribution in the same year when an election with regard to such assets is advantageous.

IX. Deductibility of Trustee Fees and Other Administration Expenses

Act §132 adds new §67, under which miscellaneous itemized deductions will be allowed to an individual only to the extent they exceed, in the aggregate, a floor equal to 2% of adjusted gross income. Under §67(b), "miscellaneous itemized deductions" include all itemized deductions other than the deductions under certain specified Code provisions. Exceptions include the deduction under §691(c) for estate tax paid on income in respect of a decedent. Section 212, the deduction for expenses for the production of income, is not one of the specified deductions.

The Conference Report indicates that, in the case of an estate or trust, deductions excluded from the application of the 2% floor are items "that are paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate . . ." [6] It may not be clear which expenses are incurred only because the property is held in trust. For instance, trustee's commissions and the cost of preparing a Form 1041 should be deductible without application of the 2% floor since those expenses are incurred only because the property is held in trust. However, expenses such as fees for a safety deposit box may be subject to the 2% floor since the trust property may have been placed in a safety deposit box even if it had not been held in trust.

The Conference Report indicates that expenses incurred by a grantor trust will be subject to the 2% floor.[7] Moreover, the 2% floor probably applies in the final year of the estate or trust when the excess administration expenses are distributed to the beneficiaries.

X. Alternative Minimum Tax

Section 58(c) provides rules for the application of the alternate minimum tax to an estate or trust. Act §1875(a) amends §58(c) to provide that both items of tax preference and itemized deductions shall be apportioned among an estate or trust and its beneficiaries in accordance with regulations provided by the Secretary.

---

[6] Conf. Rep. at p. II-34.
[7] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 48

THE NEW GENERATION-SKIPPING TRANSFER TAX CONTAINED IN THE TAX REFORM ACT OF 1986, H.R. 3838

Lloyd Leva Plaine*
Sutherland, Asbill & Brennan
Washington, D.C.
and
Atlanta, Georgia

I. Pre-TRA Law

As part of the Tax Reform Act of 1976 (P.L. 94-455), a generation-skipping transfer tax ("GSTT") was introduced into the Internal Revenue Code of 1954 as Chapter 13.[1] In general, the pre-TRA GSTT was imposed on transfers which resulted from trusts in which beneficiaries assigned to two or more generations younger than the grantor's generation could be benefited from the same assets ("generation-skipping trusts").

The GSTT applied not only to a trust but also to a " 'generation-skipping trust equivalent' . . . which, although not a trust, had substantially the same effect as a generation-skipping trust." [2] Examples of this are "arrangements involving life estates and remainders, estates for years, insurance and annuities, and split interests." [3]

A generation-skipping transfer under pre-TRA law took the form of either a "taxable distribution" or a "taxable termination" with respect to a generation-skipping trust or trust equivalent.[4] There was no generation-skipping transfer for purposes of the GSTT if the transfer was subject to federal gift tax or estate tax.[5]

In very general terms, a "taxable distribution" meant any distribution out of corpus (in the fiduciary accounting sense) from a generation-skipping trust to a beneficiary who was assigned to a generation younger than the grantor's generation (a "younger generation beneficiary") and who was assigned to a generation younger than any other younger generation beneficiary of the trust. An individual who at no time had anything other than a future interest or power (or both) in the trust was not considered to be a younger generation beneficiary.[6] The most typical example of a taxable distribution would be a corpus distribution to the grantor's grandchild from a trust for the benefit of the grantor's children and grandchildren.

A "taxable termination," stated very generally, was the termination (by death, lapse of time, exercise or nonexercise, or otherwise) of an interest or power in a generation-skipping trust of any younger generation beneficiary who was assigned to any generation older than the generation assignment of any other person who was a younger generation beneficiary of that trust. Further, it did not include a termination of an interest or power of a person who at no time had anything other than a future interest or power (or both) in the trust.[7] Where more than one beneficiary was assigned to a single generation, the taxable termination did not occur until the interest of the last of those beneficiaries terminated.[8] The most typical example of a taxable termination would be the death of the last surviving child of the grantor, where the trust is for the benefit of the grantor's children and grandchildren.

Taxable distributions and taxable terminations did not include transfers up to a limit of $250,000 per deemed transferor to a grandchild of the grantor which vested in the grandchild when the child's generation's interest ended.[9]

A person was considered to be a beneficiary of a trust if he or she either had a present or future interest or power in the trust. Although there were certain exceptions to this, even a remote possibility of receiving trust income or corpus was treated as an interest. The rules concerning who had an interest or a power; when an interest or power was a "future" or "present" interest or power; and when an interest or power terminated were among the most complicated in the GSTT area and made the determination of

* With appreciation to Richard Covey, Esq., Mildred Kalik, Esq., and Pam Schneider, Esq., for their ideas with respect to the new generation-skipping transfer tax.

[1] Section references are to the Internal Revenue Code of 1986, unless otherwise specified. A detailed description of the pre-TRA GSTT is beyond the scope of this article. *See* Covey, *Generation-Skipping Transfers in Trust*, (Rev. Ed., 1977); Kalik and Kartiganer, "Tax on Certain Generation-Skipping Transfers," American Bar Association, Section of Real Property, Probate and Trust Law, Annual Meeting Outlines (Aug. 2, 1983).

[2] §2611(d)(1) of the Internal Revenue Code of 1954, as amended (hereinafter "1954 Code").

[3] §2611(d)(2), 1954 Code.

[4] §2611(a), 1954 Code.

[5] §2613(a)(4)(B) and §2613(b)(5)(B), 1954 Code.

[6] §2613(a), 1954 Code.

[7] §2613(b), 1954 Code.

[8] §2613(b)(2)(A), 1954 Code.

[9] §2613(a)(4)(A); §2613(b)(5)(A); §2613(b)(6), 1954 Code.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

when a taxable termination actually occurred extremely complex.[10]

The tax was imposed only if and when a generation-skipping transfer actually occurred. The GSTT was designed to be substantially equivalent to the tax which would have been imposed if the property had actually been transferred outright to each successive generation. The federal estate or gift tax bracket of a member of the skipped generation (a "deemed transferor") [11] was used as a measuring rod for purposes of determining the tax imposed on the generation-skipping transfer.

The tax was extremely complicated and a trap for the unwary. It applied to trusts no matter what the size of the generation-skipping transfer and thereby required trustees to examine all transfers from trusts to determine if they were generation-skipping transfers which would give rise to the GSTT. The law was so complex that the only final regulations which were promulgated dealt with the effective date provisions and the tax return filing requirements. Other regulations which were proposed in 1981 were extensively criticized and were never made final. Further, as will be explained in more detail below, it was possible through very sophisticated planning to avoid, minimize and defer the application of the tax.

II. Legislative History of the TRA 1986 GSTT

The repeal of the pre-TRA GSTT had been strongly urged by the American Bar Association and the American Bankers Association and bills were proposed for its repeal.

On November 4, 1981, the Treasury Department testified before the Senate Finance Subcommittee on Estate and Gift Taxation with respect to S. 1695, a bill in the 97th Congress to repeal the GSTT. At that time, the Treasury Department asserted that it was opposed to repeal and in favor of modifying the GSTT provisions.

In a letter dated April 29, 1983, from John E. Chapoton, Assistant Treasury Secretary for Tax Policy, to Senator Steven D. Symms, Chairman of the Senate Finance Subcommittee on Estate and Gift Taxation, the Treasury Department submitted a proposal with the stated goal of simplifying and improving the GSTT. The proposal stated that it was not simply an attempt to patch up some of the problems of the GSTT, but it was a "fundamentally different and far simpler approach to the problem of generation-skipping." A draft of statutory language to implement the April 29, 1983 Treasury proposal was released on November 9, 1983, with revised drafts released January 6, 1984, and February 2, 1984. The Treasury proposal was the basis for H.R. 6260 which was introduced on September 18, 1984, in the 98th Congress.

On November 27, 1984, the Treasury Department issued to the President its Report on Tax Simplification and Tax Reform ("Treasury I") which contained a GSTT which was based on the latest draft of the April 29, 1983 Treasury proposal. On May 29, 1985, the President signed The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity which omitted the GSTT proposal. The September 1985 Joint Committee on Taxation Options contained a GSTT which, although based upon the April 29, 1983 Treasury proposal, made several changes in it. The proposed Tax Reform Act of 1985, H.R. 3838 (99th Cong., 1st Sess. (1985)), passed by the House of Representatives on December 17, 1985, contained a GSTT which made further changes in the April 29, 1983 Treasury proposal. The proposed Tax Reform Act of 1985, H.R. 3838, which passed the Senate, did not have a provision with respect to the GSTT; it, therefore, would have continued the old GSTT. The Conference Report on the Tax Reform Act of 1986 ("the Act"), filed on September 18, 1986, adopted the House version of the GSTT with some amendments. The House and Senate passed the Conference Report on September 25, 1986, and September 27, 1986, respectively. The Act was enacted when the President signed it into law on October 22, 1986.

Specifically, consistent with the approach taken in the April 29, 1983 Treasury proposal, the GSTT contained in the Act as proposed by the House Ways and Means Committee was specifically designed to amend:

> "the existing generation-skipping transfer tax, which attempts to determine the additional gift or estate tax that would have been paid if property had been transferred directly from one generation to another," and it imposes a simplified tax determined at a flat rate. "The generation-skipping transfer tax is expanded to include direct generation-skipping transfers (*e.g.*, a direct transfer from a grandparent to a grandchild) as well as transfers (subject to tax under the existing tax) in which benefits are 'shared' by beneficiaries in more than one younger generation." [12]

The GSTT in the Act made six fundamental changes in the GSTT system. First, under the TRA 1986 GSTT, Code §2631(a), every individual is permitted to make transfers aggregating as much as $1,000,000 during his or her lifetime or at death which, if an allocation of the exemption is made, are wholly exempt from the GSTT. In addition, *inter vivos* transfers that qualify for the applicable exclusions from the federal gift tax are also excluded for GSTT purposes as are transfers from a trust, which if made *inter vivos* by an individual, would not be treated as taxable gifts under §2503(e) relating to the exclusion of certain transfers for educational or medical expenses. The old $250,000 per deemed transferor grandchild exclusion from the GSTT was eliminated. Second, the "deemed transferor" concept was eliminated and a flat rate of tax is imposed on the non-exempt transfers, *i.e.*, the transfers not covered by the exemptions or the applicable federal gift tax exclusions. Under Code §2641, they are taxed at a flat rate equal to the maximum federal estate tax rate in effect at the time of the transfer. Third, distributions of income are subject to the GSTT. Fourth, the tax applies only to current interests. Fifth, the GSTT does not apply to powers at all. Sixth, the tax applies to direct skips, *i.e.*, transfers subject to federal estate tax or gift tax where all interests in the property are

[10] §2613(d); §2613(e); §2613(b)(2), 1954 Code. *See* text accompanying notes 18-23, *infra*.

[11] §2612, 1954 Code.

[12] H.R. Rep. No. 426, 99th Cong., 1st Sess. 824 (1985). (hereinafter "Report").

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

transferred to or held for the benefit of recipients at least two generations below that of the transferor without the payment of federal estate or gift tax in an intervening generation. However, under Act §1433(b)(3), there is a $2,000,000 exemption per grandchild for each transferor for direct skips made before 1990 to grandchildren of the transferor which vest in the grandchild.

The TRA 1986 GSTT is somewhat less complex than the pre-TRA GSTT, but it is not a simple and workable alternative to the pre-TRA GSTT. For example, it ignores future interests, and the exemptions could take most trusts out of the scope of the tax. However, it retains the most complex aspects of the pre-TRA GSTT, which include the determination of: 1) who has an "interest" in the generationskipping trust, and 2) when that interest terminates. The GSTT is postponed until actual distributions are made to lower generation beneficiaries or until all interests in the higher generations terminate. Further, the TRA 1986 GSTT, as did the pre-TRA GSTT, contains many interrelated complex definitions.

Although the $1,000,000 exemption is a good mechanism for narrowing the scope of the GSTT, in the case of transfers in excess of the $1,000,000 exemption, the high level of the flat rate on such transfers causes the exemption to lose much of its effect. This is because the transfers above $1,000,000 are not permitted to run up the federal estate tax brackets. They are taxed at the maximum federal estate tax bracket as though the prior $1,000,000 exempt generation-skipping transfer were not exempt but were a taxable generation-skipping transfer. Further, because the $1,000,000 exemptions are not freely transferable between spouses, drafting to ensure that the $1,000,000 exemptions are utilized is very difficult.

III. The Department of the Treasury and the House Ways and Means Committee Cite Problems with the Pre-TRA GSTT

In Treasury I, the Treasury, in explaining why changes in the GSTT were necessary, pointed out the following problems with the pre-TRA GSTT:

(1) The scope of the pre-TRA GSTT was overbroad which meant that every trust (no matter how small in size) which had beneficiaries in two or more generations below the generation of the grantor, was a generation-skipping trust subject to the provisions of Chapter 13. Such trusts were found in even the simplest wills. The broad scope of the tax, combined with its complexity, was likely to result in a high level of inadvertent noncompliance and, therefore, an uneven application of the tax.

(2) The complexity of the pre-TRA tax (which included no fewer than thirteen defined terms fitting into an intricate pattern of rules and exceptions) made it difficult to understand and caused additional planning costs which were borne by taxpayers and the government.

(3) The difficulties associated with administering the tax were such that the record keeping which the IRS had to undertake would have been extremely costly and perhaps close to impossible. Specifically, the IRS had to keep records of federal estate and gift tax information regarding every individual regardless of whether the individual had ever filed a federal gift tax return or his estate had ever filed a federal estate tax return.

(4) The effectiveness of the pre-TRA GSTT was questioned. Because of its numerous exceptions, it was possible through the sophisticated mechanisms (described below) for the more well-to-do individuals to avoid, minimize and defer the application of the GSTT. Therefore, the tax was deemed to be unfair because it benefited the very well-to-do as compared to families of more modest wealth.

The House Ways and Means Committee in its Report said that its reasons for change were attributable to its belief:

> as it stated when the generation-skipping transfer tax originally was enacted in 1976, . . . the purpose of the three transfer taxes (gift, estate, and generation-skipping) is not only to raise revenues, but also to do so in a manner that has as nearly as possible a uniform effect. This policy is best served when transfer tax consequences do not vary widely depending on whether property is transferred outright to immediately succeeding generations or is transferred in ways that skip generations. The committee determined that the present generation-skipping transfer tax is unduly complicated. Therefore, the committee determined that this tax should be replaced with a simplified tax, determined at a flat rate. The bill accomplishes the committee's goal of simplified administration while ensuring that transfers having a similar substantial effect will be subject to tax in a similar manner.[13]

For reasons set forth below, it is submitted that the TRA 1986 GSTT does not fully accomplish the Committee's goal.

A. Sophisticated Mechanisms For Minimizing The Old GSTT

The following outlines some of the sophisticated mechanisms for avoiding, minimizing and deferring the application of the pre-TRA GSTT.[14]

1. The GSTT could be avoided in small estates if the instrument was drafted in a way to take advantage of the $250,000 per deemed transferor grandchild exclusion from the GSTT by ensuring that the distributions to grandchildren vested at the time of the generation-skipping transfer.

2. The GSTT could be minimized through *layering*. This was only possible if the individual had enough assets to totally skip his children's generation with some of those assets. Layering involved establishing separate trusts for each generation level instead of having one trust for all generations. For example, a client with $4,000,000 and two children could have established a trust of $1,500,000 for his children for life with the remainder passing to the grandchildren. Of that amount, $500,000 would have qualified

[13] Report, p. 824.

[14] For a detailed explanation *see*, Kalik and Kartiganer, "Administration of Generation-Skipping Trusts," *39th N.Y.U. Inst. Fed. Tax.* §51 (1981); Kalik and Kartiganer, Tax on Certain Generation-Skipping Transfers, American Bar Association, Section of Real Property, Probate and Trust Law, Annual Meeting Outlines (Aug. 2, 1983).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

for the grandchild exclusion and the other $2,500,000 ($4,000,000 minus $1,500,000) could have been placed in a trust for the grandchildren for life with the remainder passing to the great grandchildren. There would have been a GSTT with respect to the remaining $1,000,000 in the first trust at the death of the client's last surviving child but there would not have been any GSTT with respect to the $2,500,000 in the second trust at the death of the child.

3. Under the income exception, in general, a distribution from current income (within the meaning of §643(b)) of the trust would not have been treated as a taxable distribution regardless of the generation level of the person to whom such distributions were made.[15] Therefore, in a spray trust benefiting several generations, if current income distributions had been made to great grandchildren there would not have been a GSTT. However, if there had been distributions of both trust income and principal in any one taxable year, then distributions of income would have been deemed to have been made to persons in descending order of generation.[16] In other words, if income had been distributed to a grandchild and principal to a child within the same taxable year of the trust, then for purposes of the GSTT, the child would have been deemed to have received a distribution of principal.

4. Further, using taxable distributions where possible was advantageous because the tax base was lower than the tax base for taxable terminations. The tax base for taxable distributions was the sum of the taxable gifts made by the deemed transferor plus generation-skipping transfers with respect to which he was the deemed transferor. By contrast, the tax base for taxable terminations was the sum of the adjusted taxable gifts made by the deemed transferor during life plus the taxable estate of the deemed transferor plus generation-skipping transfers with respect to which he was the deemed transferor.[17]

5. By changing the identity of the deemed transferor to a less well-to-do individual, the GSTT could be minimized because the tax base for the GSTT would have been lowered.

6. Further, by taking advantage of some of the most complex provisions in the pre-1986 GSTT (*i.e.*, those determining when there is a termination of an interest or power), the GSTT could be deferred. These rules operated to defer the GSTT until the termination of the last power or interest in a given generation level when the property then benefited a younger generation level. However, these rules were very complex because it was often difficult to determine when an interest or power had terminated as well as when someone had an interest or power.[18] Because it was the Congressional intent that the GSTT be imposed "only once each generation with respect to the same trust share or interest," [19] there was a deferral of the tax under the following circumstances:

a. When there was a termination of a younger generation beneficiary's interest or power but there was another younger generation beneficiary of the same generation who at the time of the termination had an interest or power in the same trust assets.[20]

b. When there was a termination of an interest or power of a younger generation beneficiary, if that beneficiary afterward continued to have an interest or power in the same trust assets.[21]

c. When there was a termination of a younger generation beneficiary's interest or power if an older generation beneficiary retained an interest or power in the same trust assets.[22]

d. When the termination of an interest or power of a younger generation beneficiary caused a new interest or power in those same assets to arise in another younger generation beneficiary who was in an older generation or the same generation as the younger generation beneficiary.[23]

IV. Overview of the GSTT Contained in the Tax Reform Act of 1986

The GSTT contained in the Act imposes a GSTT on all transfers which result in the avoidance of the federal estate and gift tax in a generation below that of the transferor. The GSTT is imposed on transfers resulting from trusts (and trust equivalents) in which beneficiaries assigned to a generation two or more generations below the transferor's generation may be benefited from the assets. ("Generation-skipping trust").

Example: A grandparent ("GP") establishes a spray trust for his child ("C") and grandchild ("GC"). If the trustee were to distribute trust income or principal to GC during C's life, that would be a generation-skipping transfer.

The GSTT would also be imposed on direct generation-skipping transfers ("direct skips") where the transferor transfers property to a beneficiary who is assigned to a generation two or more generations below the transferor's generation, and the transfer is a taxable gift or is includible in the estate of the transferor.

Example: A GP transfers $50,000 to GC. The amount which is a taxable gift (after the $10,000 annual exclusion), $40,000, is a generation-skipping transfer.

[15] §2613(a)(1), 1954 Code.
[16] §2613(a)(2), 1954 Code.
[17] §2602, 1954 Code.
[18] The proposed regulations with respect to these sections were issued on January 2, 1981 in the Federal Register as §§26.2611-26.2613. There has been much criticism of the regulations, and they were never adopted as final. The Treasury itself has said that it was very difficult if not impossible to draft regulations for the old GSTT. One example of the complexity under the proposed regulations was that a Uniform Gifts to Minor Act account established by a grandparent for a grandchild was a generation-skipping trust equivalent. The child, if he was not the custodian, was considered to have a future interest because his right to the property was contingent upon the happening of an event outside his control. His future interest would have remained future and there would not have been a GSTT imposed at the time of the child's death unless the property was used to fulfill his legal obligations. Prop. Regs. §§26.2613-4(d) and 4(e), *Example 3.*
[19] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, at 572.
[20] §2613(b)(2)(A), 1954 Code.
[21] §2613(b)(2)(B), 1954 Code.
[22] §2613(b)(2)(C), 1954 Code.
[23] §2613(b)(2)(D), 1954 Code.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The following exemptions are contained in the new GSTT: transfers which, if made *inter vivos* by an individual, would not be treated as taxable gifts because of §2503(e) relating to the exclusion of certain transfers for educational or medical expenses; *inter vivos* transfers which were not taxable gifts because of the $10,000 annual exclusion under §2503(b); the $1,000,000 exemption for generation-skipping transfers; and the $2,000,000 per grandchild exemptions with respect to direct skip generation-skipping transfers made before 1990 from a transferor to the transferor's grandchild which vest in the grandchild.

V. Detailed Explanation of the GSTT Contained in the Tax Reform Act of 1986

Many of the provisions of the TRA 1986 GSTT raise the same issues as the pre-1986 GSTT. Therefore, it will be helpful in understanding the new tax to refer to certain portions of the regulations and proposed regulations dealing with the pre-1986 GSTT, *e.g.*, the effective date rules contained in Regs. §26.2601-1 and the proposed nominal interest rules contained in Prop. Regs. §26.2613-2(b)(3).

A. Definitions

As was true of the pre-1986 GSTT, the TRA 1986 GSTT contains many interrelated terms and definitions. Understanding the meaning of those terms is critical to comprehending the tax.

1. Generation-Skipping Transfer

A generation-skipping transfer is a transfer of *income or corpus* to a beneficiary who is assigned to a generation at least two generations below the generation of the transferor, *i.e.*, only transfers to grandchildren or younger generations are subject to tax.

Example: An outright transfer to C is not a generation-skipping transfer, but a transfer from GP to GC would be (if C were alive). Generation-skipping transfers include "taxable distributions," "taxable terminations" and "direct skips." [24] The term GSTT does not include a transfer to the extent the transfer is subject to a federal gift tax or estate tax with respect to a beneficiary assigned to the first generation below that of the transferor, and any transfer which, if made *inter vivos* by an individual, would not be treated as a taxable gift because of §2503(e) relating to the exclusion of certain educational or medical expenses. It does not include any *inter vivos* transfer which is exempt from federal gift tax by reason of §2503(e) or by reason of §2503(b) relating to the annual exclusion from the federal gift tax.[25]

2. Trust/Trustee

The term trust includes any arrangement (other than an estate) which, although not a trust, has substantially the same effect as a trust, such as a life estate, remainder, estate for years, insurance and annuity contracts.[26] A trust in which beneficiaries with present interests are assigned to a generation which is two or more generations below that of the transferor's generation is a generation-skipping trust. Substantially separate and independent shares of different beneficiaries are treated as separate trusts.[27] In the case of an arrangement which is not a trust but is treated as a trust, the person in actual or constructive possession of the property is considered to be the trustee.[28]

3. Transferor

Establishing the identity of the transferor is the first step in determining whether there has been a generation-skipping transfer. In a transfer of a kind which is subject to federal estate tax, the decedent is the transferor.[29] In a transfer of a kind which is subject to federal gift tax, the donor is the transferor.[30]

If a couple were to gift-split (under §2513), the transfer would be treated as made one-half by each spouse for purposes of the GSTT.[31] Therefore, each spouse is the transferor with respect to one-half of the transfer which means both spouses' exemptions may be used for the transfer of one spouse's assets. This helps to ensure that both spouses will be able to use their exemptions even if their ownership of property is uneven.

In the case of qualified terminable interest property ("QTIP") where a martial deduction was allowed for federal gift [32] or estate tax purposes,[33] the donee spouse or the surviving spouse, as the case may be, would be treated as the transferor with respect to generation-skipping transfers occurring upon the property's disposition by (or on the death of) the transferor's spouse. The donor spouse or the estate of the decedent, respectively, may elect to treat such property for purposes of the GSTT as though the QTIP election had not been made.[34] This election makes the donor spouse or the decedent, as the case may be, the transferor. As will be explained more fully below, if the election were made and the donor spouse or the estate of the decedent, as the case may be, were the transferor, the transferor's exemption (which might otherwise have been wasted) could be allocated to property with respect to which generation-skipping transfers will occur upon the property's disposition by (or on the death of) the transferor's spouse.

4. Interest

The determination of whether a person has an interest for purposes of the GSTT is one of the keys to the application of the GSTT. The term is used in many of the other definitions. A person has an interest if the person:

a. Has a right (other than a future right) to receive income or corpus from the trust.

Example: A person with a life estate;

b. Is a permissible current recipient of income or corpus (and is not described in §2055(a)).

[24] §2611(a).
[25] §2611(b) and Report p. 826.
[26] §2652(b)(1) and (3).
[27] §2654(b).
[28] §2652(b)(2).
[29] §2652(a)(1)(A).
[30] §2652(a)(1)(B).
[31] §2652(a)(2).
[32] §2523(f).
[33] §2056(b)(7).
[34] §2652(a)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Example: A current beneficiary of a spray trust; or

c. Is described in §2055(a) and the trust is a charitable remainder annuity trust, a charitable remainder unitrust or a pooled income fund.

An interest which is used primarily to postpone or avoid the GSTT will be disregarded.[35]

5. Skip Person/Non-Skip Person

The definitions of "skip persons" and "non-skip persons" are complex and confusing because the new GSTT uses each term in defining the other term. The new GSTT uses the term "skip person" to refer to:

a. A person assigned to a generation which is two or more generations below the transferor's generation assignment.

Example: A grandchild of the transferor;

b. A trust if all interests in such trust are held by skip persons.

Example: A trust for the benefit of the grandchildren ("GC") and great grandchildren ("GGC") of the transferor; or

c. A trust if no person is holding an interest in the trust and at no time after the transfer may a distribution be made from such trust to a non-skip person.

Example: A trust for the ultimate benefit of the grandchild of the transferor, under the terms of which, for the first ten years, the trustee is to accumulate income and make no distributions of income or principal.[36]

A "non-skip person" is defined as any person who is not a skip person.[37]

6. Taxable Events

There are three types of generation-skipping transfers under the GSTT: "taxable distributions," "taxable terminations," and "direct skips."[38]

a. A "taxable distribution" occurs when there is a distribution of income or principal from a trust (other than a taxable termination or a direct skip) to a skip person, *i.e.*, a distribution of income or principal from a trust to a beneficiary who is assigned to a generation which is two or more generations below that of the transferor's generation.[39] The distribution must not be subject to federal gift tax or estate tax with respect to a person in the first generation below that of the transferor. Any transfer from a trust which, if made *inter vivos* by an individual, would not be treated as a taxable gift by reason of §2503(e) (relating to exclusion of certain transfers for educational and medical expenses) would be excluded from the term "generation-skipping transfer" and, therefore, would not be a taxable distribution.

Example: A trust established by GP for C. If the trustee were to make a distribution to GC (during the life of C), that distribution would be a taxable distribution.

b. A "taxable termination" occurs when there is a termination (by death, lapse of time, release of power, or otherwise) of an interest of a beneficiary in property held in a trust if the beneficiary is assigned to a generation which is older than that of any other beneficiary with an interest in the property and if the other beneficiaries with an interest in such property are all assigned to generations which are at least two generations below the transferor. The termination must not be subject to federal gift tax or estate tax with respect to a person in the first generation below that of the transferor. It is a taxable termination unless:

(i) Immediately after the termination, a non-skip person has an interest in such property; or

(ii) At no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

The taxable termination does not occur until the interests of all other non-skip persons end.[40]

Example: A trust established by GP for C and GC. At the death of C, there would be a taxable termination if GC were alive and if there were no other trust beneficiary with an interest who was in the same generation as C or in an older generation.

Example: A trust established for transferor's wife for 5 years, then to GC for 5 years with remainder payable to C. When the wife dies, there is a termination of an interest in property held in trust immediately after which there is not a non-skip person with an interest in the property. Therefore, it is not excepted from the definition of a taxable termination under §2612(a)(1)(A). The only non-skip person, C, has only a future right to trust property and that does not give him an interest. After the termination, distribution will be made to a skip person, GC. Therefore, the termination is not excepted from the definition of a taxable termination by §2612(a)(1)(B). It is a taxable termination even though C, a non-skip person, has a vested remainder in the property.

If, upon the termination of an interest in property held in a trust a specified portion of trust assets is distributed to skip persons who are lineal descendants of the holder of such interest (or to one or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.[41]

From a planning perspective, you can defer GSTT by having several non-skip beneficiaries so that the taxable termination will not occur until the termination of all such non-skip beneficiaries' interests. The beneficiaries must have interests which are not nominal, and the trust should not have substantially separate and independent shares of

[35] §2652(c). The concept of what is a nominal interest is a complex one. The proposed regulations under the old GSTT are a useful guide. Prop. Regs. §26.2613-2(b)(3).
[36] §2613(a).
[37] §2613(b).
[38] §2611(a).
[39] §2612(b).
[40] §2612(a)(1).
[41] §2612(a)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

different beneficiaries or else the taxable termination will not be deferred.

c. A "direct skip" is a transfer, subject to federal estate tax or gift tax, of an interest in property to a skip person (*i.e.*, a transfer for the benefit of a person assigned to a generation at least two generations below the transferor). This includes a transfer, subject to federal estate tax or gift tax, to a trust where there are no persons with an interest who are not skip persons.[42]

Example: GP transfers property outright to GC or to an irrevocable trust solely for the benefit of GC (C, who is parent of GC, is alive). The transfer is a gift for federal gift tax purposes, and it is a direct skip for GSTT purposes.

If a grandchild is the beneficiary but his parent, who is a lineal descendant of the transferor (or of the transferor's spouse or former spouse), is deceased at the time of the transfer, then there is not a direct skip because (for purposes of determining whether there is a direct skip) the grandchild is treated as though he were the child and all lineal descendants of the grandchild are moved up a generation.[43]

B. Taxation of Multiple Skips

Where a single trust provides for transfers to more than one generation of younger generation beneficiaries, the property (unless an exemption is allocated to it) is subject to transfer tax with respect to each generation.

Example: A trust for transferor's C for life, then for transferor's GC for life with remainder to transferor's GGC would be subject to transfer tax three times, *i.e.*, federal gift or estate tax when the trust was established, and to a GSTT both at the death of the C and at the death of the GC. If there is a generation-skipping transfer and immediately after such transfer the property is held in trust, then §2653 provides that for purposes of the GSTT (other than generation assignment) the trust is treated as if the transferor were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately before the generation-skipping transfer.

Example: A trust for transferor's C for life, then for transferor's GC for life with remainder to transferor's GGC, would be subject to transfer tax three times, *i.e.*, federal gift or estate tax when the trust was established, and to a GSTT both at the death of the C and at the death of the GC. However, distributions from the trust during GC's life after C's death would not be considered taxable distributions because the transferor would be considered to be in the C's generation.

Where the §2653 adjustment is made to the transferor's generation, the inclusion ratio is not affected, but proper adjustment shall be made to the inclusion ratio with respect to such trust, as prescribed in regulations, to take into account any GSTT borne by such trust which is imposed on such generation-skipping transfers. However, if the generation-skipping transfer involves a pour-over from one trust to another, §2653 provides that the inclusion ratio for the new trust shall be determined by treating the nontax portion of such distribution (*i.e.*, the amount of such distribution multiplied by the applicable fraction) as if it were part of a generation-skipping transfer exemption allocated to such trust.

There is not a double GSTT where two generations are skipped. Therefore, a double skip is a good method for saving transfer taxes.

Example: Transferor gives $2,000,000 to GC. The GSTT (if no exemptions apply) is the same for this transfer as it would be for a gift by transferor of $2,000,000 to GGC.

Example: Transferor creates a spray trust for C, GC, and GGC. GC dies before C. GC's death is not a taxable termination because C, a non-skip person, still has an interest in the trust. Then, C dies. This a taxable termination. Thereafter, the oldest generation level with an interest in the trust is GGC. The transferor is deemed to be in GC's generation. Therefore, a distribution to GGC is not a taxable distribution (because GGC is not a skip person as he is only one generation below the transferor).

C. Taxable Amount Before Exemptions and Before Inclusion Ratio

The taxable amount does not include the amount of any federal estate tax or gift tax payable with respect to a transfer. To determine the taxable amount for purposes of the GSTT, property is normally valued at it fair market value at the time of the generation-skipping transfer reduced by the amount of any consideration furnished by the transferee.[44] Where a direct skip is included in the transferor's gross estate, the value is the value for purposes of the federal estate tax — taking into account §2032 and §2032A.[45] With respect to taxable terminations which occur at an individual's death, an election can be made to value all such property in taxable terminations in accordance with §2032 (even if the estate does not elect §2032).[46]

The taxable amount is determined in a different manner for the different types of generation-skipping transfers. The determination of the taxable amount generally parallels the determination of the taxable amount in the most closely analogous transfer subject to federal estate or gift tax.

The taxable amount for a taxable distribution is the fair market value, at the time of distribution, of the property received by the transferee reduced by any expenses incurred by the transferee in connection with the determination, collection or refund of GSTT with respect to such taxable distribution.[47] It includes the GSTT itself and, therefore, is tax inclusive. If any GSTT, with respect to a taxable distribution, is paid out of the trust (instead of by the transferee), an amount equal to the GSTT paid shall be treated as a taxable distribution.[48]

[42] §2612(c)(1).
[43] §2612(c)(2). (*N.B.*: *See* footnote 80 and accompanying text.)
[44] §2624(a) and (d).
[45] §2624(b).
[46] §2624(c).
[47] §2621(a).
[48] §2621(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The taxable amount for a taxable termination is the fair market value, at time of the termination, of all the property with respect to which the taxable termination has occurred, reduced by the allowable deduction similar to the deduction allowed by §2053 (relating to expenses, indebtedness, and taxes) for amounts attributable to the property with respect to which the taxable termination has occurred.[49] It includes the amount of the GSTT itself and, therefore, is tax inclusive.

The taxable amount for a taxable distribution or for a taxable termination is supposed to accord with the transfer tax treatment which would obtain if the transfer had been made to a member of the skipped generation who then left the property at death to the ultimate transferee. This assumes that the member of the skipped generation had a federal estate tax base which was subject to the maximum federal estate tax rates and had not taken advantage of federal estate tax deductions such as the marital deduction or the charitable deduction.

The tax inclusive nature of taxable distributions and taxable terminations lead to extremely high levels of GSTT. It would be preferable to have all the generation-skipping transfer taxable amounts be determined on a tax exclusive basis.

The taxable amount for a direct skip is the fair market value at the time of the transfer of only the property received by the transferee.[50] It does not include any federal gift or estate tax payable with respect to such transfer. It does not include the GSTT itself and, therefore, is tax exclusive.

The formula to determine the GSTT taxable amount for a direct skip where the GSTT is paid out of the property is:

$$\frac{\text{total amount transferred after payment of estate or gift tax}}{100\% + \text{maximum federal estate tax rate}}$$

(Therefore 155% in 1986 and 1987 and 150% thereafter).

Example: If GP in 1988 were to bequeath $4,500,000 net of estate tax to a GC, the GSTT would be paid by the GP's estate out of the $4,500,000 but only on the amount actually received by the GC. To determine what the GC received, the fraction above is used. The GSTT on that bequest in 1988 would be 50% of $3,000,000, or $1,500,000; determined as follows:

$$\$4{,}500{,}000 \div 150\% = \$3{,}000{,}000$$

When the direct skip is also a taxable gift, the amount of the gift for purposes of the federal gift tax shall be increased by the amount of any GSTT imposed on the transferor with respect to the gift.[51]

The treatment of direct skips is alleged to parallel the tax treatment which would apply if the transfer had been made to a member of the skipped generation who then immediately used the property (net of transfer tax) to make a gift to the ultimate recipient and to pay the gift tax thereon. Further, it is not supposed to impose a GSTT higher than the transfer tax which would have been paid in the skipped generation had the property passed through that generation. However, it assumes that the member of the skipped generation would already have made so many gifts that he would be in the maximum federal gift tax bracket.

D. Liability for GSTT

Unless directed pursuant to the governing instrument by specific reference to the GSTT, the GSTT on a transfer shall be charged to the property constituting the transfer.[52]

Example: Assume a decedent were to leave $1,000,000 outright to GC and none of the $1,000,000 or $2,000,000 exemptions were allocated to it. If the decedent's will stated that all federal estate tax were payable out of the residue but did not mention the GSTT, then the GSTT will be paid by the estate from the $1,000,000 bequest. The GC would receive $666,667 and 50% of that amount, $333,333, would be paid by the estate as GSTT on the bequest.

Therefore, it is advisable to reexamine tax clauses and determine whether they need to be changed or a new provision should be added to be sure the GSTT is paid out of the desired assets.

In the case of a taxable distribution, the transferee is liable for the GSTT.[53] The trustee is liable for the GSTT in the case of a taxable termination.[54] In the case of a direct skip not from a trust, the transferor is liable for the GSTT, and in the case of a direct skip from a trust, the trustee is liable for the GSTT.[55]

E. Exemptions

1. Predeceased Child Exclusion

A transfer is not considered to be a direct skip where the transfer is made to a grandchild of the transferor (or of the transferor's spouse or former spouse) and, at the time of the transfer, the parent of such individual who is a lineal descendant of the transferor (or of the transferor's spouse or former spouse) is dead. The grandchild is treated as if such individual were a child of the transferor and all of that grandchild's children are treated as if they were grandchildren of the transferor. This is reapplied in the case of lineal descendants below a grandchild.[56]

2. Gift Tax Exclusions

The GSTT does not apply to any transfer which, if made *inter vivos* by an individual, would not be treated as a taxable gift by reason of the exclusion under §2503(e) for certain tuition or medical payments.[57] Code §2642(c) also

[49] §2622.
[50] §2623.
[51] §2515.
[52] §2603(b).
[53] §2603(a)(1).
[54] §2603(a)(2).
[55] §2603(a)(2) and (3).
[56] §2612(c)(2). (*N.B.*: *See* footnote 80 and accompanying text.)
[57] §2611(b)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

provides that any *inter vivos* transfer which is exempt from federal gift tax because of either the §2503(e) exclusion or the §2503(b) $10,000 annual exclusion is exempt from the GSTT.[58]

3. $1,000,000 Exemption

Under the TRA 1986 GSTT every individual is entitled to make cumulative transfers, during his lifetime or at death, of up to $1,000,000 without any GSTT being imposed on the generation-skipping transfers made from such property. Once a transfer, or portion of a transfer, is designated as exempt because the exemption was allocated to it, all subsequent generation-skipping transfers of such assets or of the income of such assets or the appreciation in such assets is also exempt from GSTT. Each individual (or his or her executor) may irrevocably allocate the $1,000,000 exemption to property transferred at any time by such individual with respect to any type of generation-skipping transfer with respect to which the individual is the transferor.[59] Therefore, a married couple is allowed a generation-skipping transfer exemption of $2,000,000; $1,000,000 for each spouse, and married individuals may elect to treat *inter vivos* transfers as made one-half by each spouse.[60]

In the case of qualified terminable interest property where a marital deduction was allowed for federal gift or estate tax purposes, an individual may allocate all or a portion of his or her exemption to property with respect to which a generation-skipping transfer will occur upon its disposition by the transferor's spouse (or on the transferor's spouse's death) as a result of a §2652(a)(3) election to treat that property for purposes of the GSTT as through the QTIP election had not been made. If the §2652(a)(3) election were made, the first spouse, *i.e.*, the original transferor, would be treated as the transferor of property with respect to which generation-skipping transfers occur upon the property's disposition by the transferor's spouse (or on the transferor's spouse's death), and, therefore, the first spouse's exemption could be allocated to such property. If the §2652(a)(3) election were not made, the property would be treated as QTIP property for purposes of the GSTT. In that case, the spouse of the first spouse would be treated as the transferor and could use his or her own exemption but not the exemption of the first spouse. Without this §2652(a)(3) election, the first spouse's exemption could be wasted if the bulk of his or her assets went into a QTIP trust.

The availability of the election would make the QTIP the more desirable marital deduction vehicle to the extent necessary to use the first spouse's exemption if otherwise the generation-skipping transfer exemption of the first spouse to die would not be used. Of course, if the QTIP trustee were to distribute all of the property from the trust outright to the surviving spouse, the first spouse's exemption could not be utilized at the death of the surviving spouse. It is not good policy to have the choice of which type of marital deduction to use be controlled by the GSTT. The exemption should have been made freely transferable between spouses as was the case in H.R. 6260, *supra.*

It should be noted that if the surviving spouse had no assets of his or her own, the surviving spouse's generation-skipping transfer exemption would be wasted if the §2652(a)(3) were effective for all of the marital deduction property. From a planning perspective, if the §2652(a)(3) election can be a partial election, the election should be made only to the extent necessary to use the first spouse's exemption. If §2652(a)(3) does not allow a partial election, then two separate marital deduction trusts should be established and one of them which is a QTIP trust should be funded with only sufficient property to use the first spouse's exemption.

In a case in which you want to use both spouses' generation-skipping transfer exemptions, it is important to ensure that the less well-to-do spouse has sufficient assets to fully utilize his or her exemption if he or she were to predecease the more well-to-do spouse. The more well-to-do spouse could establish an *inter vivos* QTIP trust for the other spouse. The donee spouse would be considered to be the transferor with respect to the disposition of the assets in the trust at his or her death as long as the §2652(a)(3) election were not made. The QTIP trust should be a trust which does a great deal of generation-skipping after the donee spouse's death, and the donee spouse's generation-skipping transfer exemption should be allocated to the trust so that the trust will be wholly or largely exempt from the GSTT.

Once a transfer, or portion of a transfer, is designated as exempt, because the exemption is allocated to it, all subsequent generation-skipping transfers of such assets (or of the income therefrom or of the appreciation in such assets) would also be exempt from the GSTT.

a. Allocation of $1,000,000 Exemption

An individual can allocate his or her exemption to property transferred at any time by the individual. Once made, the allocation is irrevocable. It can be made by the individual during life on a timely filed federal gift tax return for *inter vivos* transfers or by filing the allocation with the Secretary in a manner to be prescribed in forms or regulations.[61] An individual or his executor can make an allocation of the exemption on or before the date for filing the individual's federal estate tax return (determined with regard to extensions) in a manner to be prescribed by the Secretary in forms or regulations.[62]

Unless an individual elects not to have §2632(b) apply, the section will cause any unused portion of the individual's generation-skipping transfer exemption (*i.e.*, the portion that has not been allocated by the individual or treated as allocated under §2632(b)(1) to a prior direct skip) to be allocated to direct skips made by an individual during life to the extent necessary to make the inclusion ratio zero, or if the direct skip exceeds the unused exemption, the entire unused exemption will be allocated to the property transferred. The unused generation-skipping transfer exemption

[58] *See also,* Report, p. 826.
[59] §2631.
[60] §2652(a)(2).
[61] §2632(a) and §§2642(b)(1) and (b)(3).
[62] §2631 and §2632(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

of an individual available at death which is not allocated within the time prescribed by §2632(a), shall be deemed allocated, first, to direct skips occurring at such individual's death and, second, to trusts of which the individual is the transferor and from which taxable distributions or taxable terminations might occur at or after his or her death. Allocation within the direct skips shall be in proportion to the values (at the time of the allocation) of such property or trust, multiplied by the inclusion ratio with respect to such property or trust. The subsequent allocations for taxable distributions and taxable terminations are made in the same manner.[63]

A transferor to a trust could allocate at the time he transfers property to a trust (or at any time thereafter) any or all of his exemption to the trust property, even if no GSTT would have been payable at that time. The value of the property at the time of the allocation would determine the amount of the exemption used regardless of its value when distributed from the trust.

If none of the property contributed to a trust were exempt, either because the exemption had already been fully used or because no allocation was made to use the exemption, all distributions from the trust to a beneficiary in a generation two or more levels below that of the grantor would be subject to a GSTT. If a grantor were to transfer property to a trust whose value exceeded the exemption amount allocated to the property, the trust would be partially exempt, and each and every generation-skipping distribution from the trust would be partially exempt from tax.

Example: If a transferor were to transfer $1,000,000 in trust for the benefit of his children and grandchildren and were to allocate $1,000,000 of his or her exemption to the trust, no part of the trust income or corpus would ever be subject to the GSTT even if the value of the trust property were to appreciate to $5,000,000 or more. If the transferor were to allocate only $500,000 of his or her exemption to the trust, only one-half of all distributions to grandchildren would be subject to the GSTT and only one-half of the trust property would be subject to the GSTT on termination of the children's interest. If, after the creation of the trust, the transferor were to allocate an additional $250,000 of his or her exemption to the trust, the exempt portion of the trust would be redetermined, based upon the values of the trust property *at the time* of the allocation. This new inclusion ratio would apply to future distributions and terminations, but generally would not change the tax treatment of any past events.[64]

This freedom from later GSTT puts a premium on making the allocation (with respect to transfers made by the transferor during life) early, before assets appreciate. It also could be desirable to allocate the exemption to assets which will appreciate. It would be beneficial to use a value freezing technique so that the value of property outside the trust would be frozen and the property with respect to which the election is made appreciates. For example, a recapitalization could be done and the common stock could be placed in the generation-skipping trust using part of the $1,000,000 exemption. Further, the exemption could be used to establish a funded irrevocable life insurance trust.

4. Direct Skip Exemptions

A transfer before 1990 from a transferor to a grandchild of the transferor (where the parent of the grandchild who is a lineal descendant of the transferor is alive) is exempt from GSTT and, therefore, is not a direct skip for purposes of the GSTT to the extent that the aggregate transfers from such transferor to such grandchild do not exceed $2,000,000. To be entitled to the exemption, as was the case under the interpretation of the old GSTT with respect to the $250,000 grandchild exemption, the property must vest in the grandchild. Therefore, when drafting for the $2,000,000 exemption it is important to be sure nothing in the instrument interferes with the vesting. For example, it is important that the minors' provision which is in most instruments would not prevent a grandchild's interest from vesting.[65] Married individuals may elect to treat the exempt transfers as made one-half by each spouse.[66]

If the transfer which qualified for the direct skip exemption was made into a trust for a grandchild, subsequent transfers from the trust to the grandchild will be taxable distributions. This results because there was no generation-skipping transfer of property when the trust was set up since the transfer was excluded from being a direct skip by §2612(c)(2). Therefore, the provisions of §2653 which would prevent this result if there had been a generation-skipping transfer are not applicable. To avoid this result, distribute outright to the grandchild instead of establishing a vested trust. A Uniform Gifts to Minors Account ("UGMA") probably should not be used because it may be considered to be a trust equivalent as it was under Prop. Reg. §26.2611-4(b), Example 7 of the old GSTT. [Hopefully, this problem will be corrected in a later technical corrections act.]

An individual cannot allocate any of the exemption to property with respect to which a direct skip will occur upon its disposition by the transferor's spouse (or on the transferor's spouse's death) as a result of a §2652(a)(3) election to treat that property for purposes of the GSTT as though the QTIP election had not been made because it would not be a direct skip when the transfer was made. It could only be a direct skip with respect to the transferor if the original transfer could be viewed as occurring at the death of the transferor's spouse. If the §2652(a)(3) election were made so that the surviving spouse were not considered the transferor, a transfer at the death of the surviving spouse to grandchildren would be treated as a taxable termination. Therefore, from a planning perspective, it is important to recognize that if the first spouse uses the §2652(a)(3) election to utilize his or her $1,000,000 exemption, neither spouse would probably be able to utilize his or her own $2,000,000 direct skip exemption with respect to the nonexempt portion of the property. This is another reason for

[63] §2632(c).
[64] Report, p. 826.
[65] §2613(a)(4)(A) and §2613(b)(5)(A) and (6), 1954 Code, and Prop. Regs. §26.2613-4(a).
[66] §2652(a)(2); Report, pp. 826-827.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

only making the §2652(a)(3) election with respect to sufficient property to utilize the first spouse's $1,000,000 exemption.

In a case in which you want to use both spouses' direct skip exemptions, it is important to ensure that the less well-to-do spouse has sufficient assets to fully utilize his or her exemptions if he or she were to predecease the more well-to-do spouse. The more well-to-do spouse could establish an *inter vivos* QTIP trust for the other spouse. The donee spouse would be considered to be the transferor with respect to the disposition of the assets in the trust at his or her death as long as the §2652(a)(3) election were not made. The QTIP trust should be a trust from which there would be direct skips at the donee spouse's death which would immediately vest in the grandchildren so that the donee spouse's direct skip exemptions would be utilized.

F. Determination of Amount of Tax at Flat Tax Rate

The GSTT equals the taxable amount multiplied by the "applicable rate" which is the product of the maximum federal estate tax rate (55% in 1986 and 1987 and 50% thereafter) and the inclusion ratio with respect to the property.[67]

G. Inclusion Ratio

The inclusion ratio is determined by *subtracting the "applicable fraction" from one* where the applicable fraction is equal to:

generation-skipping transfer exemption allocated to trust (or to direct skip)
÷
value of property transferred to trust (or in direct skip) reduced by: (1) Federal or state death tax recovered from the trust attributable to such property, and (2) charitable deductions under §2055 or §2522 with respect to such property.[68]

The nontax or exempt portion of a trust equals the applicable fraction times the value of all property in the trust.[69]

Increasing the numerator or decreasing the denominator will create a larger applicable fraction thereby making the inclusion ratio smaller and the generation-skipping transfer smaller. If an individual transferred $1,500,000 to a charitable remainder trust where the value of the charitable interest was $500,000 and the individual allocated his entire $1,000,000 exemption to the trust, all transfers from the trust would be wholly exempt from the GSTT.

Where a transfer (other than a nontaxable gift) is made to a trust in existence before the transfer, the inclusion ratio is recomputed as of the time of such transfer. Further, if any allocation of the generation-skipping transfer exemption to property transferred to a trust is late, *i.e.*, it is not made on a timely filed required gift tax return and there was a previous allocation with respect to property transferred to such trust, the inclusion ratio is recomputed [70] as follows:

One *minus*

GST exemption allocated to property plus nontax portion of trust immediately before transfer
÷
value of property involved in transfer reduced by any charitable deductions under §2055 or §2522 with respect to such property plus the value of all property in trust immediately before transfer.[71]

The *value* used in the denominator of these applicable fractions is the value of the property at the time of the transfer or the direct skip except as set forth below:[72]

1. If the allocation of the generation-skipping transfer exemption is made on a timely filed federal gift tax return required by §6019 or is deemed made to direct skips made during lifetime under §2632(b)(1), the value of such property shall be its value for federal gift tax purposes and such allocation shall be effective from the date of the transfer.[73] If the allocation is not so made, but is made during the transferor's life, the value shall be determined as of the time such allocation is filed with the Secretary and shall be effective from the date of filing.[74]

2. The value of property transferred as a result of death of the transferor is its value for purposes of the federal estate tax and allocations at or after the transferor's death shall be effective from the date of death.[75] However, if the alternate valuation date or special use value is checked for federal estate tax purposes, this is unclear because the flush language of §2642(a) indicates the denominator in such case is the value "at the time of the transfer to the trust (or the direct skip)."

3. If QTIP property is included in a surviving spouse's estate and if the surviving spouse is treated as the transferor under §2652(a), the value of such property shall be its value for purposes of the federal estate tax in the surviving spouse's estate.[76]

Amounts transferred *inter vivos* in a direct skip which are nontaxable gifts because of the $10,000 annual exclusion under §2503(b) (taking into account gift-splitting under §2513) or certain payments to the providers of educational or medical services under §2503(e) will lead to a zero inclusion ratio. Transfers which are nontaxable gifts (which are not direct skips) and which are made to a trust will not be included in the denominator of the applicable fraction used to determine the inclusion ratio and, if it is the first such transfer to a trust, will lead to a zero inclusion ratio.[77]

If there is a generation-skipping transfer and immediately after the transfer such property is held in trust, then §2653 provides that the inclusion ratio is not affected. However, if the generation-skipping transfer involves a pour-over from one trust to another, the inclusion ratio for

[67] §2602 and §2641.
[68] §2642.
[69] §2642(d)(3).
[70] §2642(d)(1) and §2642(d)(4).
[71] §2642(d)(2).
[72] §2642(b).
[73] §2642(b)(1).
[74] §2642(b)(3).
[75] §2642(b)(2).
[76] §2642(b)(4).
[77] §2642(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the new trust shall be determined by treating the nontax portion of such distribution (*i.e.*, the amount of such distribution multiplied by the applicable fraction) as if it were part of a generation-skipping transfer exemption allocated to such trust.

VI. Practical Issues Involved in Planning for the Use of Exemptions and Exclusions

A. Value of Total Assets and Necessity to Plan to be Able to Utilize the Exemptions

If the value of a single person's assets or the value of a couple's total assets (after payment of death taxes) will be under $1,000,000 at the death of the single person or the death of the surviving spouse, any generation-skipping transfers would be totally exempt from the GSTT. If the value of a couple's total assets at the death of the surviving spouse (after payment of death taxes) will be between $1,000,000 and $2,000,000, then the couple's total assets could be exempt from the GSTT if the assets were titled correctly and if the testamentary instruments were written so that each spouse could use his or her $1,000,000 exemption.

It is important to ensure that the less well-to-do spouse has sufficient assets to fully utilize the available $1,000,000 and $2,000,000 exemptions regardless of the order of death. This should be done through gifts to the spouse, either outright or in a marital trust. In order to prevent the imposition of a federal estate tax at the death of the first spouse when the first spouse uses the $1,000,000 exemption, it would be necessary to establish a QTIP trust, with respect to which an election would be made under §2652(a)(3) to treat the first spouse to die as the transferor with respect to generation-skipping transfers occurring after the death of the surviving spouse.

To the extent that (after payment of death taxes) the value of a single person's assets will exceed $1,000,000 or the value of a couple's assets will exceed $2,000,000 at the death of the single person or the death of the surviving spouse, it is necessary to do more complicated planning to try to ensure the use of each person's exemptions and minimize the GSTT and other transfer taxes.

B. Inter Vivos Planning Using Exemptions and Exclusions

1. The Annual Exclusion from the Federal Gift Tax

Because the GSTT does not apply to any *inter vivos* transfer which is exempt from the federal gift tax by virtue of the annual exclusion, presumably one could add property to a grandfathered pre-September 26, 1985 irrevocable trust which, if the additions qualify for the annual exclusion and do not exceed the available annual exclusion, should not cause the property in the grandfathered trust to be subject to the GSTT.

Although the GSTT does not apply to any *inter vivos* transfer which is exempt from the federal gift tax, use of annual exclusion transfers must be planned carefully. The use of the annual exclusion must be coordinated with the use of the $1,000,000 exemption; otherwise the property, although transferred to the trust in a nontaxable transfer, can be subject to a later GSTT. Section 2642(c)(2) provides that if the first transfer to a trust (other than a direct skip) is a nontaxable gift, the inclusion ratio for such trust is "0". It also provides that subsequent transfers of nontaxable gifts (other than direct skips) to a trust will not be included in the denominator of the applicable fraction used to determine the inclusion ratio.[78] This can cause the property transferred to the trust as a nontaxable gift to be subject to a later GSTT where the inclusion ratio is not "0".

Example: If an irrevocable trust were established and funded with $30,000 for a child for life with remainder to grandchild, the child's income interest would qualify for the §2503(b) annual exclusion. If the child was 20 at the time of the transfer, the value of the child's life estate is $29,209.50 (Regs. §25.2512-5). If the transferor does not make any allocation of his or her exemption to the trust, then all of the property in the trust would later be subject to the GSTT. On the other hand, if $790.50 of the exemption (the amount equal to the taxable transfer to the trust) were allocated to the trust, then the property would be exempt from the GSTT.

(a) No exemption allocated to property transferred to the trust:

applicable fraction = 0 ÷ 790.50 = 0; inclusion ratio = 1.

(b) $790.50 of exemption allocated to property transferred to the trust:

applicable fraction = 790.50 ÷ 790.50 = 1; inclusion ratio = 0.

As the example demonstrates, it is important to make sure that a trust to which a nontaxable transfer is made has a sufficient amount of the $1,000,000 exemption allocated to property in the trust so that the benefit of the exclusion for nontaxable transfers is not lost. As the example also illustrates, coordinating the use of the annual exclusion and the $1,000,000 exemptions can allow the leveraged use of the exemptions, *i.e.*, where the amount transferred is higher than the amount of the exemption that needs to be allocated to it to cause a "0" inclusion ratio. On the other hand, if none of the exemption is allocated so that the numerator of the applicable fraction is "0", the nontaxable transfers will be totally subject to the GSTT. Particularly in the case of an insurance trust this can be a very valuable planning tool.

In using the annual exclusion, it is important to use property the value of which is readily ascertainable. Otherwise, if a sufficient amount of the $1,000,000 exemption has not been allocated to the trust and the IRS later adjusts the value of the gift, the inclusion ratio would be changed — perhaps when it was too late to allocate any additional portion of the $1,000,000 exemption to it.

2. $1,000,000 Exemptions

It may be difficult to determine whether and when to use the $1,000,000 exemptions *inter vivos*. To determine when and how the exemptions should be used involves consideration of the following factors which are difficult to predict:

[78] §2642(c).

(a) Determining whether and when generation-skipping transfers will occur from the property to which the $1,000,000 exemptions are to be allocated. If the "exempt" property is distributed to non-skip persons, the $1,000,000 exemption would be wasted.

(b) Determining to which assets the allocation of the $1,000,000 exemptions should be made, *i.e.*, which assets have the most appreciation potential, and determining when to allocate the exemptions. The freedom from later GSTT puts a premium on making the allocation in a timely manner with respect to transfers made by the transferor during life before assets appreciate and on allocating it to assets which will appreciate. It would be beneficial to use a value freezing technique so that the value of property outside the exempt trust would be frozen and the property with respect to which the allocation is made would appreciate. However, if a transferor believes the assets are likely to decrease in value, the transferor would be better off not allocating the exemption when the transfer is made (and electing out of a deemed allocation in the case of a direct skip).

Example: A recapitalization could be done and the common stock could be placed in the exempt trust. Further, the exemption could be allocated to a funded irrevocable life insurance trust which had only a small present value. The property could be used to purchase a remainder interest in a joint purchase of an asset.

(c) Determining which spouse's exemption should be utilized, *i.e.*, whether to gift split or whether to establish an *inter vivos* QTIP trust and elect under §2652(a)(3) to have the donor spouse be treated as the transferor.

If the $1,000,000 exemption were used *inter vivos*, it would be beneficial to put it in a separate trust because the client might want the terms of the exempt trust to provide for as much generation-skipping transfers as possible whereas the provisions of the nonexempt trusts could have less generation-skipping transfers. Moreover, to the extent that assets in excess of the exempt portion are subject to GSTT, it would be easier from an administrative perspective to have one trust that is fully exempt and another that is fully taxable.

To use the $1,000,000 exemption *inter vivos*, a present federal gift tax would have to be paid when the trust was funded (unless a QTIP trust was used). In some situations, this might not be a good utilization of the unified credit. It might be more desirable for non-GSTT reasons to use the unified credit in a more leveraged situation, such as a grantor income trust.

An *inter vivos* QTIP trust could be established and the donor could elect to be treated as the transferor under §2652(a)(3). In that way there would be no present federal gift tax, the unified credit would not be used, and any future appreciation in the property would be free from GSTT. However, such a trust may be disadvantageous because of distributions which will be made from the trust before and after the death of the donee spouse. Specifically, the trust income has to be distributed out to the donee spouse currently, trust principal could be distributed to the donee spouse, and federal estate tax could be paid at the death of the donee spouse from the trust. There appears to be no adjustment for the federal estate taxes payable at the donee spouse's death. Further, if the donor or donee spouse provides that such taxes are to be paid out of other funds, the payment may be considered to be an addition to the QTIP trust for generation-skipping transfer purposes. Therefore, much of the exemption would have been wasted.

It is also desirable to use the $1,000,000 exemption in a leveraged fashion, for example, as mentioned above, through the use of annual exclusions. In addition, its use can be leveraged if it is allocated to a charitable lead trust. Where property is transferred to a charitable lead trust, the inclusion ratio is reduced because the value of the charitable interest is deducted from the value of the property in the denominator of the applicable fraction. Therefore, although eventually all of the property originally placed in the trust will probably pass to the remaindermen, only an amount of the $1,000,000 exemption equal to the present value of the remainder interest needs to be allocated to the trust to exempt all transfers under the trust from the GSTT. If $1,500,000 is placed in the trust and the present charitable deduction is $500,000, only $1,000,000 of the exemption must be used to exempt the whole $1,500,000 in the trust (plus any later appreciation) from future GSTT.

The spouses could gift-split and the transfer would be treated as made one-half by each spouse. This is helpful where the poorer spouse does not have sufficient assets to fully use the $1,000,000 exemption.[79] Where one of the spouses has already used part of the $1,000,000 exemption, it might be preferable first to make a gift to the other spouse to be sure that each spouse is considered to be the transferor with respect to assets equal to that spouse's unused $1,000,000 exemption.

3. $2,000,000 Exemptions

The $1,000,000 exemptions shelter the property from all future GSTT whereas the $2,000,000 per grandchild exemptions only prevent the taxation of a direct skip made before 1990 which vests in the transferor's grandchild and, therefore, will be subject to federal estate tax at the grandchild's death. Therefore, in using the $2,000,000 exemptions, one should be careful that the $1,000,000 exemption is not overlooked.

It may be desirable to use the $2,000,000 direct skip exemptions *inter vivos* because they are only available through 1989. Moreover, as the federal gift tax is a tax exclusive tax, less transfer tax would be paid if the transfer were made by gift than if it were made at death (so long as the donor survives the gift by three years). The Treasury Department is considering a proposal to make the federal gift tax a tax inclusive tax.

Furthermore, the spouses could treat *inter vivos* transfers as made one-half by each spouse if the poorer spouse did not have sufficient assets to use the $2,000,000 exemptions.

As stated above, it is not possible for the donor spouse by establishing a QTIP trust with respect to which he elects to be considered the transferor under §2652(a)(3) to utilize his $2,000,000 exemptions for transfers to grandchildren at

[79] §2652(a)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the end of the QTIP. On the other hand, if the donee spouse were the transferor and the grandchildren were the remaindermen, there would be a direct skip with respect to which the donee spouse's $2,000,000 exemptions could be applied if the donee spouse died before 1990 and the transfer vested in the grandchildren.

The $2,000,000 exemption cannot be used to exempt generation-skipping transfers from a charitable lead trust to grandchildren who are the remaindermen. A transfer to such a charitable lead trust would not be treated as a direct skip at the time of the transfer to the trust because §2651(e)(3) would assign the charitable beneficiary to the transferor's generation and, therefore, the trust would not be a skip person. If, as is often the case, a transferor were to set up a charitable lead trust for charity for a term of years with property passing to his or her grandchildren at the end of the charity's interest, there would not be a direct skip when the trust was established because of the charity's interest and its assignment to the transferor's generation. The generation-skipping transfer would occur at the end of the charity's interest when the trust property would be likely to have appreciated. However, because there would not be a federal gift tax or estate tax at the end of the charity's interest, the generation-skipping transfer would be a taxable termination — not a direct skip, and therefore, the transferor's $2,000,000 per grandchild direct skip exemptions could not be used to exempt the generation-skipping transfer.

C. Testamentary Use of Exemptions and Exclusions

To the extent that the client has not used the available exemptions during life, it is important to be sure they are utilized after death. Further, even if the client has decided to use the exemptions during life, it is advisable to draft provisions in the client's will or trust as a safety net which would utilize the exemptions to the extent that they are still available at death. Planning and drafting for the testamentary use of the $1,000,000 exemptions is complex and planning and drafting for the use of the $2,000,000 exemptions, which are available only until 1990, superimposes additional complexities.

1. Planning for the Use of the Predeceased Child Exclusion

Because the application of this provision is determined by who happens to be alive at the time of the transfer, it is not really possible to plan to take advantage of it. However, in determining whether to make the election under §2652(a)(3) to treat the first spouse as the transferor, one should recognize that, if at the end of the QTIP trust there is a transfer to grandchildren, and the first spouse to die is the transferor, there will be a taxable termination. However, if the surviving spouse is the transferor, there is a chance that the child who is the parent of the grandchild and a child of one or both of the spouses might die during the surviving spouse's life. In that case, at the end of the QTIP trust, there would not be a direct skip because of the child's intervening death and, therefore, a GSTT would have been avoided.

N.B.: A transfer to a trust for the grandchild whose parent (who was a lineal descendant of the transferor, or of the transferor's spouse or former spouse) was deceased at the time of the transfer would not be a direct skip.[80] However, the way the GSTT provisions are drafted, subsequent distributions from the trust to the grandchild would be taxable distributions. Although the provisions of §2653 would prevent this result in a case where there was a direct skip to the trust because it would cause the transferor for subsequent generation-skipping transfers to be treated as though he or she were in the child's generation, §2653 would have no application to this situation because there was no generation-skipping transfer of property when the trust was set up since the transfer was excluded from being a direct skip by §2612(c)(2). To avoid this result, instead of establishing a trust for the grandchild, consider distributing outright to the grandchild.

2. $1,000,000 Exemptions

If the client's assets exceed the available $1,000,000 exemption, it might be appropriate to place property to which the $1,000,000 exemption will be allocated in a separate trust. Having a separate trust for the $1,000,000 exemption amount enables the trust to be used for reverse freezes, *i.e.*, property with the most appreciation potential could be placed in the trust or the trust could hold common stock from a recapitalization or it could purchase a remainder interest in a joint purchase of assets. Moreover, the client might want the terms of the exempt trust to provide for as much generation-skipping transfers as possible whereas the provisions of the nonexempt trusts could have less generation-skipping transfers. Furthermore, to the extent that assets in excess of the exempt portion are subject to the GSTT, it would be easier from an administrative perspective to have one trust that is fully exempt and another that is fully taxable.

To utilize the available $1,000,000 exemption by use of separate trusts, the will could contain a formula clause. To utilize the $1,000,000 exemption when the client wants the same terms as in other trusts established under the will, the executor could be given the power to allocate the exemption and divide the property into separate trusts. Therefore, although the terms of the trusts would be identical, one would be wholly exempt and the other would be subject to the GSTT. On the death of the first spouse, part of the $1,000,000 exemption can be used through the unified credit and the rest through the QTIP by making the election that the decedent will be considered to be the transferor with respect to the QTIP under §2652(a)(3). If it is done through the QTIP, you may be allowed to make a partial election (*Note:* this is not specifically covered in the statute) although, for purposes of administrative ease, you might want to use a separate trust for the exempt portion.

The executor could be directed to set up two separate trusts which could have either identical or different terms applicable after the death of the surviving spouse. The QTIP with respect to which the first spouse wanted to be the transferor would be funded by the executor with $1,000,000 and then the rest of the martial property could be placed in a second QTIP trust. One difference in the two QTIP trust provisions could be that at the death of the

[80] §2612(c)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

surviving spouse, all federal estate tax would be payable out of the nonexempt marital deduction trust so that the exempt amount would not be depleted. The surviving spouse's will could provide that all estate tax is to be paid out of the residue of his or her estate. One potential consequence of either of these tax payment provisions would be that the payment of the federal estate tax could be treated as a constructive addition to the trust for purposes of the GSTT. Further, using the QTIP for the first spouse's exemption has the further disadvantage, referred to above, that distributions from the QTIP trust to the surviving spouse deplete the exempt property and, effectively, waste a portion of the exemption.

3. When Should the First Spouse Elect to be Treated as the Transferor Under §2652(a)(3) with Respect to QTIP?

The first spouse will want to elect to be treated as the transferor with respect to enough of the QTIP trust, whether *inter vivos* or testamentary, to use the portion of his or her $1,000,000 exemption which would not otherwise be utilized. There is always the risk that the exemption could be wasted if the assets were distributed out of the QTIP to the donee or surviving spouse.

Except for the reason set forth in the above paragraph, it is probably preferable to have the donee or surviving spouse, as the case may be, be the transferor. First, the surviving or donee spouse can use the property to utilize his or her $1,000,000 and $2,000,000 exemptions if he or she does not have sufficient other assets to use them. Second, allocation of the $1,000,000 exemption to the QTIP, as described above, means that a portion of the exemption will be wasted because of distributions to the donee or surviving spouse and because of the estate tax payable at the death of the donee or surviving spouse. Moreover, if the child of one of the spouses dies during the life of the surviving spouse and the QTIP at his or her death goes outright to that child's child, a GSTT can be avoided because the transfer to the grandchild would not be considered a direct skip.[81] Finally, if the transfer from the QTIP at the death of the surviving spouse is to the grandchild or to a trust for the grandchild and the surviving spouse is considered to be the transferor, it will be a direct skip which is tax exclusive. If the first spouse had been treated as the transferor, the transfer to the grandchild would be a taxable termination which is tax inclusive.

4. $2,000,000 Exemptions

Because the transfer must vest in the grandchild to qualify for the $2,000,000 exemption, it is important to examine existing wills and trusts to see if they contain direct skips and if the direct skips vest if the transferor dies before 1990. If the distributions are outright to the grandchild, be sure the instrument's minors provision will not prevent the vesting. It may be desirable not to change the client's will until January 1, 1987 because, if the client dies before January 1, 1987, all generation-skipping transfers under a will executed before enactment would be exempt from the GSTT.[82]

If the transferor is the first spouse to die, it is impossible to use the $2,000,000 direct skip exemptions in his or her will or trust in excess of the unified credit amount without incurring a present federal estate tax. This is because, as stated above, the QTIP election under §2652(a)(3) that enables the first spouse to be considered the transferor and therefore use the first spouse's $1,000,000 exemption would not help in this situation since the transfer would not be a direct skip at the death of the first spouse in view of the surviving spouse's intervening interest. Therefore, if the first spouse wants to use his or her $2,000,000 exemptions, he or she should either use them during life or have a provision in the will or trust to utilize the exemptions.

Suppose the transferor is a surviving spouse, his $2,000,000 exemptions have not been used during life, and he dies before 1990. If he has assets in excess of the $1,000,000 exemption and wants to benefit his grandchildren and skip his children, then the will could have a provision that bequeaths property equal to the amount of the still available $2,000,000 exemption to each grandchild outright or to a trust for the benefit of each grandchild. Instead of making a specific bequest at the death of a surviving spouse to utilize the surviving spouse's $2,000,000 exemptions, if the marital deduction was a non-QTIP or a QTIP where the surviving spouse was considered to be the transferor under §2652(a), a provision could be used which would take property which would otherwise be a direct skip and vest it in the grandchildren.

5. Interrelationship of $1,000,000 and $2,000,000 Exemptions

When drafting testamentary instruments to utilize both spouses' $1,000,000 exemptions and the surviving spouse's $2,000,000 exemptions, it might be desirable to use more than one marital trust.

The first spouse could establish a QTIP trust and elect under §2652(a)(3) to be considered the transferor so that his or her $1,000,000 exemption could be allocated to that trust. In order to use the surviving spouse's $1,000,000 exemption, either a separate QTIP trust could be established, or the election referred to above could be made with respect to only part of the QTIP, so that the surviving spouse would be considered to be the transferor of enough property to use his or her $1,000,000 exemption.

Further, the QTIP itself could have a formula in it which would take effect at the death of the surviving spouse to establish different dispositions after the surviving spouse's death. The portion with respect to which the first spouse was considered to be the transferor under §2652(a)(3) could be directed to be distributed at the death of the surviving spouse to a trust which contains a great deal of generation-skipping transfers. In the portion with respect to which the surviving spouse was the transferor, the formula could provide that an amount equal to the surviving spouse's available $1,000,000 exemption after the surviving spouse's death would be distributed to a trust which contains a great deal of generation-skipping transfers. It could provide that if the surviving spouse died before 1990, the $2,000,000 exemptions would next be used, and if he or she died after 1989, a different disposi-

[81] §2612(c)(2).
[82] §1433(b)(2)(B) of the Act.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tion of the property would be made. It is important that the $2,000,000 exemptions be made with property that is not exempt from the GSTT, otherwise the exemption would be partially wasted.

It is important to give the surviving spouse a special testamentary power of appointment (to appoint outright or in trust among his or her lineal descendants and perhaps to appoint to and establish a charitable trust) so that, if he or she is the transferor, he or she can change the disposition of the property at the time of his or her death, as necessary to use his or her $1,000,000 exemption in a way that does a great deal of generation-skipping transfers. Further, if he or she died before 1990, he or she could appoint the property to grandchildren and vest the property so that it too would qualify for the $2,000,000 exemptions. If he or she died after 1989, the power would give added flexibility to plan for generation-skipping transfers.

In order to get the $2,000,000 exemption, the property must vest in the grandchild at the death of the transferor. Therefore, the trustee, as is suggested above with respect to the $1,000,000 exemptions (where there is no vesting requirement), to have the discretion to divide the property into two trusts at the death of the transferor, one of which would vest and one of which would not.

D. Planning If Assets Exceed the Exemptions

The following points should be considered for planning very large estates:

(1) Once the exemptions have been fully utilized there are not any significant transfer tax reasons to keep property in a trust. Each $1.00 of additional generation-skipping transfers which is not covered by an exemption will be taxed at the top marginal federal gift and estate tax bracket (55% in 1986 and 1987 and 50% after 1987). Not only are the GSTT rates equivalent to the top federal estate and gift tax brackets, therefore, using the progressive brackets, the GSTT does not have a marital deduction, nor does it have a credit for tax paid on prior transfers.

(2) One advantage of keeping property in a trust is tax deferral. Through the use of a spray trust, the GSTT could be deferred until the death of the last member of a generation.

(3) There are, of course, many valid nontax reasons for keeping property in a trust.

(4) Whether a transfer is made in or out of a trust, a transfer can be made, which does not benefit child or grandchild, to a great-grandchild, *i.e.*, a double skip with the imposition of only one GSTT.

(5) The drafting of the trusts, as was the case under the old GSTT, should be very flexible and allow the trustee a lot of discretion. The drafting should allow the trustee the discretion to transfer property to beneficiaries so the property can be subject to federal estate or gift tax rather than to the GSTT because the former will probably be less expensive as the examples below demonstrate. In addition to giving the trustee the power to distribute property to the beneficiaries, the beneficiaries could be given special powers of appointment which an independent trustee could be empowered to turn into general powers.

(6) In some situations the GSTT could be higher than the federal estate tax avoided by skipping a generation. This could be the case, for example, because the exemption covers $1,000,000 of generation-skipping transfers and then the GSTT is a flat 55% in 1986 (50% after 1987). On the other hand, if property in excess of the generation-skipping exemption were subject to federal estate tax in the intervening generation, the beneficiary's unified credit could be used and the beneficiary's marital deduction, charitable deduction and federal estate tax brackets could be used. Therefore, it could be advantageous to establish a generation-skipping transfer trust which would utilize the available exemptions and then have the excess property vest in the intervening generation — at least to the point where the beneficiary's federal estate tax brackets have been utilized.

(7) After the exemptions have been used, non-exempt generation-skipping transfers can be more expensive than the federal gift tax. Therefore, it could be advantageous to cause a transfer of property to be subject to a federal gift tax rather than the GSTT. For example, a taxable distribution of $1,000 from a generation-skipping trust to a grandchild of the transferor in 1986 or 1987 would produce a $550 GSTT and the grandchild (who would be liable for the tax) would only have $450 left after taxes. If, on the other hand, the trustee distributed $1,000 to the transferor's child, there would not be a GSTT. The child could give the $1,000 to the grandchild and use his annual exclusion or unified credit so that no federal gift tax would be due. If the child had already used his or her annual exclusion and unified credit and was in the 55% gift tax bracket, he could give $645 to the grandchild and pay $355 in federal gift tax. In the GSTT situation the grandchild received a net of $450, whereas in the gift situation the grandchild received a net of at least $645.

(8) The GSTT rate can seem confiscatory. In certain situations, when combined with the federal estate tax that also must be paid, the total transfer tax equals 300% of the property received by the beneficiary. The following examples illustrate the effect of the tax after 1987 when the maximum federal estate and gift tax bracket will be 50%, in the tax exclusive direct skip (examples 1 and 2) and in the tax inclusive taxable termination (example 3).

Example 1: If a transferor who was in the 50% federal gift tax bracket were to make a gift in 1988 of $3,000,000 to his grandchild and did not apply any of his annual exclusion or $1,000,000 exemption to the transfer, and if the transfer did not qualify for the $2,000,000 direct skip exemption, he would have to pay $1,500,000 in GSTT and $2,250,000 in federal gift tax or a total of $3,750,000 in transfer taxes in order to transfer only $3,000,000. Therefore, the transferor had to use $6,750,000 in total assets in order to get less than 44.5% of those assets, $3,000,000, to his grandchild; more than 55.5% of the total assets were used to pay transfer taxes. The total transfer tax is 125% of the value of the property received by the grandchild.

Example 2: If a transferor who was in the 50% federal estate tax bracket were to make a bequest in 1988 of $3,000,000 to his grandchild and did not apply any of his $1,000,000 exemption to the transfer, and if the transfer did not qualify for the $2,000,000 direct

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

skip exemption, he would have to pay $1,500,000 in GSTT and $4,500,000 in federal estate tax or a total of $6,000,000 in federal transfer taxes in order to transfer only $3,000,000 to the grandchild. Therefore, the transferor had to use $9,000,000 in assets in order to get one third of those assets, $3,000,000, to his grandchild; two-thirds of the total assets were used to pay transfer tax. The total transfer tax is 200% of the value of the property received by the grandchild.

Example 3: If a transferor who was in the 50% federal estate tax bracket created a testamentary trust for children for life with the remainder to grandchildren, then, assuming the transferor did not apply his $1,000,000 exemption to the transfer, it would require $12,000,000 of the transferor's property to leave $3,000,000 to the grandchildren. From the $12,000,000, $6,000,000 of federal estate tax would be paid and if the $6,000,000 remaining property were the value of the property at the death of the children, $3,000,000 would be paid in GSTT and only $3,000,000 would be received by the grandchildren. Therefore, the transferor had to use $12,000,000 in total assets in order to get 25% of those assets, $3,000,000, to the grandchildren; $9,000,000, 75% of the total assets, was used to pay transfer taxes. The total transfer tax is 300% of the value of the property received by the grandchildren.

The GSTT is lower for direct skips than for taxable terminations or taxable distributions because the taxable amount for direct skips is tax exclusive whereas the taxable amount for taxable terminations and taxable distributions is tax inclusive. The GSTT for direct skips, although lower, must be paid earlier. Therefore, a tension is created between the type of generation-skipping transfer and the amount and timing of the GSTT. If the client wants to keep the property in trust and there will be generation-skipping transfers in excess of the exemptions, you need to decide whether to structure the generation-skipping transfers as direct skips or taxable terminations. A direct skip is tax exclusive but it is taxed early and at the earlier values than the tax inclusive taxable termination. If one expects the property to appreciate considerably, it could be preferable to use a direct skip.

VII. Miscellaneous Provisions

A. Generation Assignment

An individual who is a lineal descendant of a grandparent of the transferor (or of the grandparent of the transferor's spouse) shall be assigned to that generation which results from comparing the number of generations between the grandparent and such individual with the number of generations between the grandparent and the transferor (or the transferor's spouse).[83] Legal adoptions and relationships by half-blood are treated as relationships of whole blood.[84] A spouse of a transferor is assigned to the same generation as the transferor. A spouse of a lineal descendant of the transferor's grandparent (or of the transferor's spouse's grandparent) is assigned to the same generation as the lineal descendant.[85]

Other individuals are assigned to generations based on their date of birth as follows:[86]

Individual's Generation Assignment	Years Between Individual's Later Date of Birth and Transferor's
Transferor's generation	Not more than 12½ years
1st generation younger than transferor	More than 12½ years but not more than 37½ years
Another generation younger	Each succeeding 25 years

Individuals who are assigned to more than one generation by these rules are assigned to the youngest generation.[87]

If an estate, trust, partnership or other entity has an interest in property, each individual with a beneficial interest is assigned to a generation based on the rules set forth above.[88]

Any charitable trust described in §511(b)(2) and any organization described in §511(a)(2) shall be assigned to the transferor's generation.[89]

B. Credit for State Taxes

A credit not exceeding 5% of the GSTT is allowed for the GSTT imposed by a state with respect to generation-skipping transfers occurring by reason of death.[90]

C. Disclaimer

A disclaimer that results in property passing to a person at least two generations below that of the original transferor results in a GSTT.[91] *Example*: If C disclaims a bequest from parent and property goes to GC of transferor, a GSTT is imposed on the transfer in addition to an estate tax. The disclaimed property is primarily liable for the payment of the GSTT.

D. Income

Generation-skipping distributions are subject to GSTT whether they are made out of income or corpus. The recipient is entitled to an income tax deduction for the GSTT imposed on the distribution of income which is included in income of the distributee and to which the throwback rules of §666 do not apply.[92]

With respect to any GSTT on a taxable termination or a direct skip occurring as a result of the death of the transferor, a deduction is allowed for the portion of the GSTT attributable to items of the gross income which were not properly includible in gross income for periods before the date of such generation-skipping transfer.[93]

[83] §2651(b)(1) and (2).
[84] §2651(b)(3).
[85] §2651(c).
[86] §2651(d).
[87] §2651(e)(1).
[88] §2651(e)(2).
[89] §2651(e)(3).
[90] §2604.
[91] §2518.
[92] §164(a)(5) and §164(b)(4).
[93] §691(c)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

E. Basis

In addition to any adjustment to basis received under the federal gift [94] or estate tax basis provisions,[95] the basis of property "transferred" in a generation-skipping transfer generally is increased (but not above fair market value) by the amount of GSTT attributable to the excess of the property's value over the transferor's basis. A taxable termination occurring as a result of death receives a step-up in basis like that provided under §1014 except that if the inclusion ratio with respect to such property is less than one, the increase in basis is limited by multiplying the increase by the inclusion ratio.[96]

F. Personal Liability of Trustee

The personal liability of trustees is limited for increases in the GSTT in certain circumstances which are beyond the trustees' knowledge or control.[97]

G. Administration Provisions

The Code provisions governing administration of the gift and estate taxes are applicable to the GSTT (to the extent not inconsistent with the GSTT). The federal estate tax rules are applicable to the GSTT occurring as a result of death, and the federal gift tax rules are applicable in other cases.[98]

H. Return Requirements

The Secretary shall prescribe by regulations the person who is required to make the GSTT return and when. To the extent practicable, the regulations are to provide that the return shall be filed by the person liable for the payment of the GSTT under §2603(a) and the return shall be filed:

1. In the case of a direct skip on or before the date on which the estate or gift tax return is required to be filed.

2. In all other cases on or before the 15th day of the fourth month after the close of the taxable year (in which such transfer occurs) of the person required to make such return.[99]

I. Extension of Time for Payment of GSTT on Direct Skips

The special rules under which federal estate tax attributable to interests in certain closely held businesses may be paid in installments is also made applicable to direct skips which occur as a result of death.[100]

J. Redemptions of Stock to Pay GSTT

Tax-free redemptions of stock to pay GSTT in the case of such transfers occurring as a result of death is added to the parallel federal estate tax provision.[101]

VIII. Effective Dates

The pre-TRA GSTT is repealed retroactive to its initial effective date — June 11, 1976.[102] The statute of limitations period for filing claims for refunds of the pre-TRA GSTT is waived to the extent a claim is filed before the date one year after the enactment of TRA-1986.[103]

The TRA 1986 GSTT applies to generation-skipping transfers after the date of enactment, except *inter vivos* generation-skipping transfers occurring after September 25, 1985 and on or before the date of enactment are treated as if made after the date of enactment and are subject to the TRA 1986 GSTT. Generation-skipping transfers from trusts that were irrevocable on September 25, 1985 are exempt to the extent that the transfers are not attributable to additions to the trust principal occurring after that date.[104]

Generation-skipping transfers under wills executed before the date of enactment are exempt if the decedent dies before January 1, 1987. This rule is only applicable to generation-skipping transfers under wills, not to trusts.[105] This is a much broader exemption than that described in the Conference Report which states that only direct skips under such wills are exempt.[106] The Concurrent Resolution [107] contained an amendment which passed both Houses which would have extended this grandfathering to generation-skipping transfers under a revocable trust executed before the date of enactment if the grantor died before January 1, 1987. The Concurrent Resolution failed to pass the Congress. The amendment may be made retroactively in a later technical corrections act in which case it would have been advisable not to amend revocable trusts executed pre-enactment between the date of enactment and January 1, 1987.

Generation-skipping transfers under a trust are exempt to the extent the trust consists of property included in the decedent's gross estate (other than property transferred by the decedent during his or her life after the date of enactment), or reinvestments thereof, or generation-skipping transfers which are direct skips occurring by reason of the death of any decedent, but in each case only if the decedent was, on the date of enactment and at all times thereafter until death, under a mental disability to change the disposition of his or her property.[108]

An election may be made to treat *inter vivos* and testamentary contingent transfers in trust for the benefit of a grandchild as vested direct skips so that the $2,000,000 exemptions can be used. The transfers must have occurred before the date of enactment of TRA-1986 and the transfers would have been vested but for the fact that the trust provides if the grandchild dies before vesting, the property is transferred to his or her heir rather than to his or her

[94] §1015.
[95] §1014.
[96] §2654(a).
[97] §2654(d).
[98] §2661.
[99] §2662.
[100] §6166(i).
[101] §303(d).

[102] §1433(c)(1) of the Act.
[103] §1433(c)(2) of the Act.
[104] §1433(b)(2)(A) of the Act.
[105] §1433(b)(2)(B) of the Act.
[106] H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-776 (1986) (hereinafter "Conference Report").
[107] H. Con. Res. 395.
[108] §1433(b)(2)(C) of the Act.

estate. Both the effective date provision [109] and the Conference Report [110] incorrectly state that the contingent transfers are not direct skips. A transfer does not need to vest to be a direct skip. The contingent transfers are direct skips, but because they do not vest they do not qualify for the $2,000,000 exemption. If the election is made, the transfer would qualify for the exemption and would be subject to federal estate tax at the grandchild's death.

IX. Planning Considerations Involving the Effective Date Provisions

One must look at the client's entire situation, but it would probably be advantageous to use pre-September 26, 1985 irrevocable trusts ("grandfathered") to do a great deal of generation-skipping transfers since they will be exempt from GSTT to the extent the transfers are made from property not added to the trust after September 25, 1985.

Consider exercising special powers of appointment in grandfathered trusts to make additional generation-skipping transfers. Also consider using disclaimers of interests in grandfathered trusts if they are still timely (for example, a minor beneficiary), to do more generation-skipping transfers. Also consider using the annual exclusion to add property to grandfathered trusts if the transfer would be of a present interest and would not exceed the allowable annual exclusion. In addition, consider establishing a new trust rather than making transfers to grandfathered trusts of other than nontaxable gifts.

Review the effective date regulations under the old GSTT to see what powers in the grandfathered trust may destroy the grandfathering and what may be considered to be a constructive addition to the trust.[111] *N.B.*: The QTIP provision was not covered by the old effective date rules because they dealt with instruments which were drafted before the QTIP provisions were enacted. Discussions on both floors of Congress pointed out that the grandfathering was intended to apply to some of the same situations that were grandfathered under the old law's effective date provisions.[112] Specifically, they said it includes a trust that contains a special power of appointment so long as the exercise of the power (including the creation of a trust) cannot result in the creation of an interest which postpones, or a new power which can be validly exercised so as to postpone, the vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the trust.[113]

If generation-skipping transfers occur under a QTIP where the will was executed before TRA-1986 was enacted and the first spouse died before January 1, 1987, try to get the benefits of grandfathering by electing under §2652(a)(3) to have the first spouse be treated as the transferor.

Consider not changing wills which were executed before the enactment date until January 1, 1987. Otherwise, if the testator died before January 1, 1987 the grandfathering would be lost. Even a codicil which republishes the will might cause this result unless it specifically states that it is not applicable unless the testator dies after December 31, 1986. Of course, if the testator's assets are below the amount of the exemption, it would not be harmful to change the will and lose the grandfathering, since all of the generation-skipping transfers would be covered by the exemption. *N.B.*: The Conference Report states that this grandfathering applies only to testamentary direct skips,[114] but the statutory language applies to all generation-skipping transfers. Be careful not to waste the first spouse's exemption which might result if he or she dies before 1987 with a non-QTIP marital deduction and the surviving spouse dies after 1986.

Where the generation-skipping transfers will occur under a funded revocable trust rather than under the will, consider amending the trust to pour the property back to the estate upon death if the grantor dies before January 1, 1987 to try to get the benefit of the grandfathering of the will. In the alternative, consider taking the property out of the trust now. *N.B.*: Be sure the provisions of the will which would then dispose of the property make generation-skipping transfers and are consistent with the wishes of the testator; otherwise this would not be advisable. For example, if the will incorporates by reference the terms of the trust, this could be a good step to take.

Where a will which was executed before the enactment date pours over to an unfunded trust, if the testator dies before January 1, 1987, argue that the generation-skipping transfers are under the will, and, therefore, should be grandfathered under §1433(b)(2)(B) of the Act. If an individual dies after January 1, 1987 and meets the mental disability requirements,[115] argue that generation-skipping transfers under a testamentary trust are covered by that section's grandfathering.

If an individual died before the enactment date and had a funded revocable trust, argue that he met the mental disability requirements on the date of enactment, and therefore, all generation-skipping transfers should be grandfathered.[116] If the generation-skipping transfers occurred before the date of enactment because they were not *inter vivos* transfers, argue that they are exempt from the GSTT.

X. Planning Steps To Be Taken

The following planning steps should be taken immediately:

(1) Reexamine existing wills and revocable trusts which were drafted under the pre-TRA GSTT. These instruments should be redrafted in light of the TRA 1986 GSTT law because the provisions relating to the pre-TRA GSTT (such as vesting to obtain the $250,000 exclusion) will no longer be beneficial and, in some cases, they would be detrimental or totally without dispositive effect.

[109] §1433(d) of the Act and Conference Report, p. II-776.
[110] Conference Report, p. II-776.
[111] Regs. §26.2601-1.
[112] 132 Cong. Rec. H.8362 (Daily Ed. Sept. 25, 1986) (remarks of Cong. Rostenkowski), S.13952 (Daily Ed. Sept. 27, 1986) (remarks of Sen. Packwood).
[113] Regs. §26.2601-1(e)(3).
[114] Conference Report, p. II-776.
[115] §1433(b)(2)(C) of the Act.
[116] §1433(b)(2)(C) of the Act.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(2) Examine existing documents to make sure a client's will and trusts can utilize the $1,000,000 exemptions. Use QTIP trust marital deduction provisions if appropriate and give the donee or surviving spouse a special testamentary power of appointment. Be sure both spouses have sufficient assets so that regardless of the order of death the exemptions can be used.

(3) Give the executor broad powers to allocate the $1,000,000 exemption.

(4) Give the executor or trustee the authority to divide any trust into two separate trusts, one of which has a GSTT inclusion ratio of "0" and one of which has a GSTT inclusion ratio of "1".

(5) Be sure generation-skipping transfers under existing wills or trusts which provide for direct skips will vest if the testator dies before 1990 in cases where the $1,000,000 exemptions have already been used. *N.B.*: You may want to wait until January 1, 1987 to have the client sign a new will because of the potential grandfathering.[117]

(6) Consider giving a disinterested trustee the ability to give, at any time, any beneficiary in a generation below the transferor's generation a general testamentary power of appointment so that the trust property would be subject to federal estate tax rather than to the GSTT.

(7) Clients who have sufficient assets should consider using the $1,000,000 and $2,000,000 exemptions to make gifts while the federal gift tax is still tax exclusive.

(8) Take advantage of the annual exclusions.

(9) Try to leverage the $1,000,000 exemption by using it in conjunction with charitable trusts and annual exclusion gifts.

(10) Examine tax clauses to see if it is necessary either to make changes in them or to add other tax clauses to be sure the GSTT is paid from the assets which you want to bear the tax.

[117] §1433(b)(2)(B) of the Act.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Summary of GSTT Provisions in the 1986 Tax Reform Act

(1) Type of Generation-Skipping Transfer	(2) Example	(3) Taxable Amount (Before Exemptions or Inclusion Ratio)	(4) Tax Inclusive or Tax Exclusive	(5) Liability for Tax	(6) Exemptions	(7) Inclusion Ratio Where Only One Transfer is Made to Trust
Taxable Termination	Trust established by grandparent(GP) for child(C) and grandchild(GC). At death of C, there is a taxable termination if GC is alive and if there is no other trust beneficiary with a present interest who is in the same generation as C or in an older generation.	Value of all property with respect to which the taxable termination has occurred reduced by the allowable deduction similar to the deduction allowed by §2053 (relating to expenses, indebtedness, and taxes) for amounts attributable to the property with respect to which the taxable termination has occurred (§2622).	Tax Inclusive. (§2622).	Trustee. (§2603(a)(2)).	Every individual is allowed a GST exemption of $1,000,000 which may be allocated by such individual (or his executor) to property transferred at any time. Married individuals may elect to treat these exempt transfers made inter vivos as made one-half by each spouse. The exemption is used to determine the inclusion ratio.	The inclusion ratio (§2642) with respect to any property transferred in a taxable termination or a taxable distribution shall be one minus: GST exemption allocated to trust divided by Value of property transferred to the trust minus (federal estate tax or state death tax actually recovered from the trust attributable to such property and any charitable deduction allowed under §2055 or §2522 with respect to such property).
Taxable Distribution	Trust established by GP for C & GC. Trustee makes a distribution to GC. That distribution is a taxable distribution.	Value of property received by transferee reduced by any expense incurred by transferee in connection with the determination, collection or refund of GSTT with respect to such taxable distribution. (§2621(a)).	Tax Inclusive. If any GSTT, with respect to a taxable distribution is paid out of the trust, (instead of by the transferee) an amount equal to the tax so paid shall be treated as a taxable distribution. (§2621(b)).	Transferee. (§2603(a)(1)).	This exemption can be used for any type of GST (§2631), but the total exemption is $1,000,000. There are specific rules governing its use (§2632). The GSTT does not apply to any inter vivos transfer which is exempt from federal gift tax by virtue of the $10,000 annual exclusion or any exclusion under §2503(e) for certain tuition or medical payments. (§2611(b)(2)).	

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(1) Type of Generation-Skipping Transfer	(2) Example	(3) Taxable Amount (Before Exemptions or Inclusion Ratio)	(4) Tax Inclusive or Tax Exclusive	(5) Liability for Tax	(6) Exemptions	(7) Inclusion Ratio Where Only One Transfer is Made to Trust
Direct Skip from a Trust	GP establishes a revocable trust which at his death is to distibute the trust assets to GC. (C who is the parent of GC is alive at GP's death.) The property in the trust is in GP's estate for purposes of the federal estate tax, and the property transferred to GC is a direct skip for GSTT purposes at GP's death.	Value of property received by transferee. (§2623).	Tax Exclusive. (§2623).	Trustee. (§2603(a)(2)).	Transfer from a a transferor to a GC of the transferor (where parent of GC is alive) is exempt from GSTT and therefore is not a direct skip for purposes of the GSTT to the extent that the transfer vests in GC, is made before 1/1/90 and the aggregate transfers from such transferor to such GC do not exceed $2,000,000. (§1433(b)(3) of TRA 1986). Married individuals may elect to treat the exempt transfers made inter vivos as made one-half by each spouse.	The inclusion ratio (§2642) with respect to any property transferred in a direct skip shall be one minus: GST exemption allocated to the property transferred divided by Value of property transferred in direct skip minus (federal estate tax or state death tax actually recovered from property transferred attributable to such property and any charitable deduction allowed under §2055 or §2522 with respect to such property).
Direct Skip not from a Trust	GP transfers property outright to GC or to an irrevocable trust solely for the benefit of GC (C who is parent of GC is alive). The transfer is a gift for federal gift tax purposes, and it is a direct skip for GSTT purposes.	Value of property received by transferee. (§2623).	Tax Exclusive. (§2623). If direct skip is taxable gift, the amount of the gift for purposes of the federal gift tax is increased by the amount of any GSTT imposed on transferor with respect to the gift. (§2515).	Transferor. (§2603(a)(3)).		

As used in chart:

GST = Generation-skipping transfer.
GSTT = Generation-skipping transfer tax.
Source of GSTT = Unless directed pursuant to the governing instrument by specific reference to the GSTT, the GSTT on a transfer shall be charged to the property constituting such transfer. (§2603(b)).

Chapter 49

MISCELLANEOUS ESTATE AND GIFT TAX PROVISIONS

Lucia N. Smeal, Esq.
Silverstein and Mullens
Washington, D.C.

I. Information Required for Valid Special Use Valuation Election

Under Code §2032A, real property used in farming or in a closely held business may be valued for estate tax purposes based on its current use rather than its fair market value.[1] The purpose of this provision is to enable heirs who want to continue operation of a farm or closely held business to do so without having to sell the property to pay the federal estate tax.[2] For §2032A to apply, the executor of an estate must file a notice of election with the estate's Federal Estate Tax Return (Form 706).[3] In addition, all persons with an interest in the property must sign an agreement consenting to the election. Specifically, qualified heirs must consent to personal liability for the additional estate tax imposed under §2032(c) if the qualified use of the property ceases within 10 years of the decedent's death.[4] Persons who are not qualified heirs but who have an interest in the property must consent to the collection of any additional estate tax from the qualified real property.[5] The agreement also must be filed with the return [6] and must be in a form which is legally binding on all parties under local law.[7]

For decedent's dying before 1982, the election documents had to filed on or before the due date of the estate tax return.[8] For decedents dying after 1981, the election and agreement must be filed with the return whether or not it is filed by the due date.[9] Therefore, the election may be made on a late return. In addition, a protective election can be filed with a *timely filed* estate tax return.[10]

The Tax Reform Act of 1984 [11] retroactively amended §2032A(d) to provide regulatory authority for perfection of a defective election which is in "substantial compliance" with the regulations within 90 days after the estate is notified of the defect.[12] However, the Conference Report to the 1984 Act indicates that merely checking the applicable election box on the return is not enough. Rather, a notice of election and an election agreement that is in substantial compliance with the regulations must be included with the return as originally filed.[13] The Report further explains that, at a minimum, the agreement as originally filed must be valid under state law and must include the signatures of all parties having a present interest or other than a *de minimis* remainder interest in the specially valued property.[14]

The Tax Reform Act of 1986 in §1421 expanded the availability of perfection of a defective election for estates of decedents dying before January 1, 1986 who were denied special use valuation because they did not submit the necessary election documents with their estate tax return.

Section 1421 of TRA 1986 [15] grants retroactive relief for estates which were denied the special use valuation election because they did not submit all of the required documents for an election with their estate tax return. Specifically, §1421 of the Act validates special use elections by estates that elected special use valuation and provided substantially all information for such election required *on the estate tax return.* Under the Act, these estates are permitted to perfect their elections within 90 days of being notified of errors or omissions by the Treasury. Thus, late filing of the required attachments is permitted. The Conference Report indicated that the provision is intended to permit estates that used the March 1982 edition of Form 706, which did not specify that the agreement had to be sent with the return, to perfect their §2032A elections.[16] The Senate Report states that notices of elections and agreements may be filed late where the estate timely filed those documents to the extent requested and described on Form 706.[17] As noted above, the estate must have substantially complied with the requirements for special use valuation enumerated on the Federal Estate Tax Return, Form 706 (as opposed to the Treasury Department regulations).[18]

This relief provision generally applies to estates of decedents dying after December 31, 1976 [19] and before

---

[1] Real estate normally must be valued at its "highest and best use" under Regs. §20.2031-1(b).
[2] H.R. Rep. No. 1380, 94th Cong., 2d Sess. 21 (August 2, 1976).
[3] Code §2032A(a)(1)(B); Regs. §20.2032A-8(a)(3).
[4] Code §2032A(d)(2); Regs. §20.2032A-8(c).
[5] *Id.*
[6] Code §2032A(a)(1)(B) and (d)(2); Regs. §20.2032A-8(a)(3).
[7] Regs. §20.2032A-8(c)(1).
[8] Code §2032A(d)(1) before amendment by P.L. 97-34, Act §421(j)(3), the Economic Recovery Tax Act of 1981.
[9] Code §2032(d)(1).
[10] Regs. §20.2032A-8(b) Note: The change in the Economic Recovery Tax Act of 1981 which permits an election for §2032A to be filed with a late return does not specifically include protective elections.
[11] P.L. 98-369, Act §1025(a).
[12] Code §2032A(d)(3)(A) and (B).
[13] H.R. Rep. No. 861, 98th Cong., 2d. Sess. 1241 (June 23, 1984).
[14] *Id.*
[15] This provision was originally added by the Senate in Sec. 1615, p.2431, of the Senate-passed version of H.R. 3838 (May 29, 1986) and does not amend the Internal Revenue Code.
[16] H.R. Rep. No. 841, 99th Cong. 2d. Sess. II-770-71 (September 18, 1986).
[17] S. Rep. No. 313, 99th Cong., 2d. Sess. 876 (May 29, 1986).
[18] Act §1421(a)(2); H.R. Rep. No. 841, 99th Cong. 2d. Sess. I-666.
[19] This is the original effective date of Code §2032A permitting perfection of special use valuation elections. P.L. 98-369, §1025(a).

January 1, 1986. However, perfection is not available if before the date of enactment of TRA 1986 (October 22, 1986), the statute of limitations has expired for (1) an estate's tax return and (2) refund or credit claims. Under Code §6075, estate tax returns must be filed within nine months after the date of the decedent's death. In addition, the executor may request an extension of up to six months to file the Form 706.[20] Generally, the IRS has three years from the later of the date the return was due or the date the return was actually filed to assess a deficiency.[21] Further, credits and refunds are not allowed unless claims are filed within three years from the time a return is filed or two years from the time the tax was paid, whichever is later.[22] Therefore, perfection is allowed only for estates which come within these time limitations as of October 22, 1986, the date of enactment of the Tax Reform Act of 1986.

II. Estate and Gift Tax Deduction for Certain Conservation Easement Donations

A. Introduction

Under §1422 of the Tax Reform Act of 1986, estate and gift tax deductions for donations of conservation easements will no longer be tested under the income tax rules defining a "conservation purpose." Although this appears to be a liberalization of pre-TRA 1986 law, this class of contributions remains subject to the uncertainty which originally led to enactment of the troublesome definition. A discussion of the history of the conservation easement provisions is necessary to put the TRA 1986 amendment in perspective.

As a general rule, estate and gift tax charitable deductions are denied for contributions of partial interests in property.[23] This restriction was originally enacted by the Tax Reform Act of 1969 (P.L. 91-172),[24] which denied tax deductions for donations of partial interests in property, except for an undivided portion of a taxpayer's entire interest in the property. However, the Conference Report on the Tax Reform Act of 1969 stated that a gift of an open space easement in gross is to be considered a gift of an undivided interest in property if the easement is in perpetuity.[25] Based on this language, the IRS in regulations [26] and rulings [27] permitted deductions for donations in perpetuity of open space, historical, and recreational easements.

Later, Code §170(f)(3)(B)(iii) was enacted [28] to permit deductions for easements having a term of 30 years. This provision was amended by §6(a) of the Tax Treatment Extension Act of 1980 (P.L. 96-541), to permit a deduction only for "qualified conservation contributions." That term was defined in a new Code §170(h), enacted by P.L. 96-541, §6(b). The §170(f)(3)(B)(iii) exception also was incorporated in Code §2055(e)(2) and §2522(c), making §170(h) applicable to donations for estate and gift tax purposes.

Code §170(h) [29] defines the term "qualified conservation contribution" as a contribution of a "qualified real property interest" to a "qualified organization," "exclusively for conservation purposes." [30] Only four specific conservation purposes will support a deduction. They are spelled out in Code §170(h)(4)(A) as follows:

> (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public;
>
> (2) the protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem;
>
> (3) the preservation of open space (including farmland and forest land) for scenic enjoyment of the general public or pursuant to a governmental conservation policy and such preservation will yield a significant public benefit; or
>
> (4) the preservation of an historically important land area or a certified historic structure.

These requirements have been very difficult to work with, primarily because of the uncertainty created by the use of such subjective terms as "relatively natural habitat," "scenic enjoyment of the public," and "significant public benefit." Although most of the major cases in this area have been on valuation, [31] the IRS rulings largely have dealt with applying these terms to prospective easement donations.[32]

Early in 1986, final regulations on qualified conservation contributions were released as T.D. 8069, 51 Fed. Reg. 1496 (January 14, 1986), effective for contributions not in trust of partial interests in property for conservation purposes made on or after December 18, 1980. These regulations list numerous factors which will be considered in testing donations under the terms set forth in the four conservation purpose requirements.

As stated above, under §1422 of TRA 1986, estate and gift tax deductions for contributions of conservation easements do not have to satisfy these income tax conservation purpose requirements.

B. Analysis

Taking estate and gift tax deductions for conservation easements out from under the income tax requirements is designed to grant relief where a deduction has been denied for income tax purposes because it did not meet one of the four specific conservation purposes outlined in §170(h)(4)(A). In that situation, under TRA 1986, taxpay-

[20] Code §6081; Regs. §20.6081-1.
[21] Code §6501(a).
[22] Code §6511(a).
[23] Code §170(f), §2055(e) and §2522(c).
[24] Code §170(f)(3)(A).
[25] H.R. Rep. No. 782, 91st Cong., 1st Sess. 294 (December 21, 1969).
[26] Regs. §1.170A-7(b)(1)(ii).
[27] Rev. Rul. 74-583, 1974-2 C.B. 80; Rev. Rul. 75-358, 1975-2 C.B. 76; and Rev. Rul. 75-373, 1975-2 C.B. 77.
[28] This exception was originally enacted by the Tax Reform Act of 1976 (P.L. 94-455, §2124(e)).
[29] A further amendment to this section was made by §1035 of the Tax Reform Act of 1984 (P.L. 98-369), which revised §170(h)(5)(B) to permit surface mining of contributed easement property under limited circumstances.
[30] Code §170(h)(1).
[31] *See Symington v. Comr.*, 87 T.C. No. 59 (1986); *Stanley Works and Subsidiaries v. Comr.*, 87 T.C. No. 22 (1986); *Akers v. Comr.*, T.C. Memo. 1977-370, *aff'd*, 799 F.2d 243 (6th Cir. 1986); and *Hilborn v. Comr.*, 85 T.C. 677 (1985).
[32] *See* PLRs 8638012, 8630056, 8626075, and 8623037. *See also Osborne v. Comr.*, 87 T.C. No. 31 (1986) and *Stark v. Comr.*, 86 T.C. 243 (1986).

ers will not be liable for increased estate and gift taxes at a later time when the income tax consequences are finally determined.

This provision originally was added by §717 of the Senate version of H.R. 3838. The Senate Finance Committee report on the easement provision explains that the provision is intended to "de-couple" the income, gift, and estate tax rules on conservation purpose requirements.[33] Under "Reasons for Change," the report gives the example of a conservation contribution being made that later is found to not satisfy the conservation purpose requirement. In this situation under current law, the report notes, the donor loses the income tax deduction and also may be subject to gift or estate tax. As a result, the charitable organization will end up owning the property and the donor may not have other funds to pay the tax.[34] In the "Explanation of Provision," the report says that the conservation purpose requirement is retained for income tax deductions. The report then simply says that, under the bill, contributions that are determined not to satisfy the income tax rules will "nonetheless not result in imposition of gift or estate tax." [35] No guidance is provided as to how the IRS should test contributions made strictly in estate and gift situations. The Conference Report on TRA 1986 gives no further explanation of the provision.[36] Also, no regulatory directive is given to Treasury regarding this change.

However, according to the statutory language, donations of conservation easements for estate and gift tax purposes will continue to have to meet the other definitions of §170(h). The contribution must be made to a qualified tax-exempt organization as defined in §170(h)(3). Moreover, the "exclusively for conservation purposes" language of §170(h)(1)(C) still applies to require that the conservation purpose be protected in perpetuity.[37]

Enactment of this provision has put conservation easement donations back where they were between 1969 and 1981, between the Conference Report language of the Tax Reform Act of 1969 and the passage of the cumbersome definition of "conservation purpose" in 1980. Taxpayers will no longer have to contend with the difficult and subjective definitions of "significant public benefit," "scenic enjoyment," and "relatively natural habitat." However, the down side to this congressional action is that the new provision does not solve the long-standing problem of uncertainty in this area of the law. Now, taxpayers have no set definition to rely upon as to what is a "conservation purpose" which will qualify the donation for an estate or gift tax deduction. This doubt could inhibit potential donors. Most observers believe that the change indicates Congress's intention to permit estate and gift deductions for broader purposes. However, the manner in which Treasury implements this intent is yet to be seen. Due to the lack of clarity which is still a part of the law, future changes in this area may be expected.

C. Effective Date

Under §1422(e) of TRA 1986, transfers occurring after December 31, 1986 do not have to meet the §170(h)(4)(A) income tax requirements for conservation easement donations.

[33] S. Rep. 313, 99th Cong., 2d Sess. 283-284.
[34] *Id.* at 284.
[35] *Id.* at 284.
[36] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-771-72.
[37] Code §170(h)(5)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 50

MODIFICATION OF EXEMPT ORGANIZATION RULES

Jerry J. McCoy, Esq.
Silverstein and Mullens
Washington, D.C.

I. Certain Title-Holding Companies Granted Tax Exemption and Debt-Financed Income Relief

A. Overview

Section 501(c)(2) grants exemption to a corporation organized to hold title to property, collect the income therefrom, and turn over the net amount thereof to another exempt organization. Exempt organizations frequently find it convenient or desirable to hold title to real estate through a separate entity because of, for example, limited liability or administrative convenience. Where one organization forms an entity to hold property for it, §501(c)(2) has been the traditional means for accomplishing this; a corporation formed by an exempt organization to hold title in this fashion will qualify for exemption under that provision. The IRS has taken the position, however, that such an organization is not tax-exempt if it has two or more parent organizations which are unrelated. *See* H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-824 (1986)("Conference Report"). Act §1603 adds Code §501(c)(25) to create a new category of exempt organization designed to provide relief from the rigid IRS interpretation of §501(c)(2). In addition, the new category of organization is exempt from the debt-financed property rules in the same manner as educational organizations and qualified pension, profit-sharing or stock bonus trusts.

B. Analysis

1. Qualification

The entity described in §501(c)(25) has the following characteristics:

a. It may be a corporation or trust;[1]

b. It may have not more than 35 shareholders or beneficiaries;[2]

c. It may have only one class of stock or beneficial interest;[3]

d. It must be organized for the exclusive purposes of acquiring real property, holding the title to and collecting the income from such property, and remitting the income (net of expenses) to one or more qualifying shareholders or beneficiaries;[4] and

e. The shareholders or beneficiaries must have certain rights, as described below.

Section 501(c)(25)(B) specifies that a corporation or trust may qualify under the new provision "without regard to whether the corporation or trust is organized by 1 or more organizations" of the appropriate type. This rule is intended to preclude the IRS from arguing that this new type of organization may have only one parent organization.[5]

The organizations which may be shareholders or beneficiaries of a §501(c)(25) title-holding company are as follows:

a. A qualified pension, profit-sharing or stock bonus plan that meets the requirements of §401(a);[6]

b. A governmental plan (within the meaning of §414(d));[7]

c. A Federal, state or local government, agency, or instrumentality;[8]

d. A §501(c)(3) organization;[9] or

e. Another §501(c)(25) organization.[10]

Note: In the case of an exempt organization not included in the foregoing list, the §50(c)(2) title-holding company will remain the only available vehicle for holding property in an exempt title-holding subsidiary.

An organization described in §501(c)(25) must permit its shareholders or beneficiaries to dismiss the organization's investment advisor, following reasonable notice, upon a majority vote of such shareholders or beneficiaries.[11] In addition, the shareholders or beneficiaries must be entitled to terminate their interest in the organization either: (1) by selling or exchanging their stock or trust interests to another qualifying organization (subject to Federal or State securities laws, and provided the sale or exchange will not increase the number of shareholders or beneficiaries above the statutory limit of 35); or (2) by having their stock or

[1] §501(c)(25)(A).
[2] §501(c)(25)(A)(i).
[3] §501(c)(25)(A)(ii).
[4] §501(c)(25)(A)(iii).

[5] *See* S. Rep. No. 313, 99th Cong., 2d Sess. 885 (1986) ("Senate Report").
[6] §501(c)(25)(C)(i).
[7] §501(c)(25)(C)(ii).
[8] §501(c)(25)(C)(iii).
[9] §501(c)(25)(C)(iv).
[10] §501(c)(25)(C)(v).
[11] §501(c)(25)(D)(i).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

interest redeemed by the corporation or trust upon 90 days notice.[12]

2. Application of Debt-Financed Income Rules

Although tax-exempt organizations are generally subject to tax on their unrelated business income, most types of passive income are excluded.[13] The general provision excluding passive income from that tax is not applicable to certain debt-financed income.[14] Section 514 of the Code taxes all exempt organizations on income from "debt-financed property." In general, property used for non-exempt purposes, and with respect to which an "acquisition indebtedness" exists, is classified as debt-financed property.[15] There are numerous exceptions and limitations under §514, including transitional and "grace period" rules which enable the use or disposition of certain encumbered property without tax consequences.[16] The Internal Revenue Service has taken the position that the unrelated debt-financed income rules are applicable to an exempt title-holding corporation described in §501(c)(2).[17]

Prior to the 1986 Act, an exception was provided under §514(c)(9) to the rule requiring taxation of income from debt-financed property. Under that exception, the term "acquisition indebtedness" does not include any indebtedness incurred by an educational institution (described in §170(b)(1)(A)(ii)) and its affiliated support organizations, or by a qualified pension trust, as a result of the acquisition or improvement of real property. As a result, the debt-financed income rules do not apply to such property.

Act §1603(b) amends §514(c)(9) by adding the title-holding organizations described in new §501(c)(25) to the list of categories qualifying under §514(c)(9) for relief from the debt-financed income rules.

C. Effective Dates

The exemption for §501(c)(25) organizations, and the accompanying amendment to the debt-financed income provisions, both apply to taxable years beginning after December 31, 1986. Act §1603(c).

D. Planning Suggestions

Creation of the new category of exempt organization expands considerably the planning alternatives available to exempt organizations with respect to their real estate activities. First, and most obviously, organizations which have been thwarted by the IRS in their attempts to combine their real estate investments in a single §501(c)(2) organization may now use the new §501(c)(25) entity to achieve the desired result. This will enable affected organizations to realize enhanced investment opportunities through the economies of scale they may achieve by pooling their resources.

The change in §514(c)(9), excusing the §501(c)(25) type of title-holding company from the debt-financed income rule, has considerable potential significance for §501(c)(3) organizations. Although designated a "clerical amendment" by §1603(b) of the Act, this change in effect permits any §501(c)(3) organization to create a §501(c)(25) organization, acquire real estate through the latter entity using borrowed funds, and avoid unrelated business income taxation on the debt-financed income produced. While the §514(c)(9) exception continues to have the same restrictions and limitations applicable under prior law, these limitations should not seriously impede the acquisition of pure investment property from an unrelated seller. Thus, subject to the limited restrictions in §514(c)(9)(B), the 1986 Act opens up a ready means for avoidance of unrelated debt-financed income for many §501(c)(3) organizations.

Exempt organizations which have heretofore utilized §501(c)(2) title-holding corporations should consider whether it may be advisable for them to restructure their operations so as to qualify under new §501(c)(25). As described above, the latter alternative offers an exemption to the debt-financed income rules and the possibility of multiple parents, neither of which is available to a §501(c)(2) organization. The §501(c)(25) organization can also provide additional planning latitude. For example, a trust can qualify under this provision whereas §501(c)(2) requires that a corporate format be used.

As with its predecessor, the §501(c)(2) title-holding company, the §501(c)(25) organization apparently cannot engage in any business other than its permitted real estate holding function.[18] However, that function may be somewhat broader in the case of the latter organization. In the case of a §501(c)(2) entity, both the Code and the regulations limit it to "the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which is itself exempt under this section [*i.e.*, §501]." [19] The permitted purposes of a §501(c)(25) organization are described in similar terms in §501(c)(25)(A)(iii), except that they include, in addition to holding title and collecting and remitting net income, the additional purpose of "*acquiring* real property." [Emphasis supplied.] There is thus a logical basis for concluding that a §501(c)(25) organization may engage in various forms of activity relating to the acquisition of real property, even though such activities might be beyond the permitted scope of a §501(c)(2) organization.

The legislative history is silent on this point, except insofar as the Senate Finance Committee Report indicated that this amendment is intended to permit "smaller, unrelated tax-exempt organizations . . . to pool investment funds for purposes of investing in real estate through a title-holding company." [20] Consider, for example, whether a §501(c)(25) organization could acquire a building by constructing it (or having it constructed by a general contractor); if the actions of the organization were in the nature of an investor's conduct (as opposed to that of a developer), this would seem to be within a reasonable construction of the permissible "acquiring" of real property. Tax Manage-

[12] §501(c)(25)(D)(ii).
[13] *See* §512(b)(1), (3), and (5).
[14] *See* §512(b)(4).
[15] §514(b).
[16] For details, *see* 339 T.M., *Unrelated Debt-Financed Income.*
[17] *See* PLR 8145011.
[18] *Cf.* Regs. §1.501(c)(2)-1(a); Rev. Rul. 58-566, 1958-2 C.B. 261.
[19] §501(c)(2). *See also* Regs. §1.501(c)(2)-1(a).
[20] Senate Report at 885.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ment understands that Treasury personnel are not sympathetic to any expansive view of the permissible activities of the new form of title-holding company; nevertheless, this possibility should not be overlooked in appropriate circumstances.

II. Exceptions to the Unrelated Business Income Rules

A. Overview

Despite their general exemption from Federal income tax, tax-exempt organizations are subject to tax under §§511-514 on their unrelated business taxable income ("UBTI"). This tax applies to the gross income derived by an exempt organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the business, both computed with various modifications. The 1986 Act includes several amendments specifying certain circumstances under which particular types of income will be exempt from the unrelated business income tax.

Specifically, the Act provides as follows:

1. An exception is provided, available only to exempt organizations described in §170(b)(2) or (3), for income received from the exchange or rental of membership or donor mailing lists with or to other exempt charitable organizations. [§513(h).]

2. An exception is provided to exempt organizations described in §170(b)(2) or (3) for income from activities related to the unsolicited distribution of low cost (not in excess of $5, adjusted for inflation) articles incidental to soliciting charitable contributions. [§513(h).]

3. The pre-1986 TRA exception for income derived from qualified trade show and convention activities of §501(c)(5) and (6) organizations is expanded: (a) to include shows or conventions where suppliers to the sponsoring organization's members sell products; and (b) to apply to §501(c)(3) and (4) organizations as well. [Amended §513(d)(3).]

B. Analysis

1. Rental of Mailing Lists

A 1981 case, *Disabled American Veterans v. U.S.*, 650 F.2d 1128 (Ct. Cl. 1981), held that income received by the Disabled American Veterans from other exempt organizations and commercial businesses for the use of its mailing list constituted unrelated business taxable income. The exception under §512(b)(2) for "royalties" was held inapplicable.

Section 1601(a) of the Act amends §513 of the Code to provide, in subsection (h)(1)(B), that the term "unrelated trade or business" does not include any trade or business consisting of either exchanging with another exempt charitable organization names and addresses of its donors or members, or renting such names and addresses to another such organization. The category of organizations to which this exemption applies are those listed in §170(c)(2) or 170(c)(3); both parties to the exchange or rental must be so described.

The effect of this statutory change is to reverse the rule of *Disabled American Veterans v. U.S., supra.* In that case, the DAV argued that income it received from other exempt organizations and commercial businesses for the use of its mailing list did not constitute unrelated business taxable income on grounds that: (1) its activities did not amount to a trade or business; and (2) in any event, the income in question represented passive royalty income excludible from unrelated business taxable income under §512(b)(2). The Court of Claims rejected both of these contentions, holding that an activity constitutes a trade or business for UBTI purposes if it is operated in a competitive, commercial manner. The DAV was found to have participated in an active direct mail industry, and operated in a competitive manner in renting its donor list. Because such rentals were not shown to have any substantial relationship to the accomplishment of its exempt purposes, except as a fundraising activity, the court found that the receipts from these rentals constituted UBTI. The royalty exclusion was held inapplicable on the ground that DAV's list rentals were the product of extensive business activity and thus did not constitute the type of "passive" income excluded under §512(b)(2).

New §513(h)(1)(B) thus reverses the rule of the DAV case on the list rental issue, but only in part. The rule exempting income from exchanges and rentals of lists applies only where the other party to the transaction is an exempt charitable organization. Income from rentals to taxable organizations, as well as tax-exempt organizations other than charities, are not exempt under §513(h)(1)(B). Also, rentals of mailing lists consisting of names other than members or donors are not covered by the 1986 amendments. Whether income from such rentals is thus taxable remains an open question. Query the effect of the amendments upon lists containing name of potential donors who, although solicited, have not yet made a contribution, or lists containing information in addition to mere names and addresses.

Although the Committee Reports contain no statement regarding the effect of §513(h) upon prior law, a floor statement by Chairman Rostenkowski of the House Ways and Means Committee indicates specifically that the new law is not to be viewed as raising any inference concerning prior law:

> "I also have discussed with Congressman Duncan the issue of whether the provision of the bill which excludes certain income from unrelated trade or business income creates any inference under present law. We have reached a common understanding regarding the following specific issue:
>
> "The question relates to Section 1601 of the bill which excludes from unrelated trade or business income revenues from the use of a tax-exempt organization's mailing list by another such organization. Section 1601 of the bill, which specifically exempts certain such revenues from the tax on unrelated business income in the future, carries no inference whatever that mailing list revenues beyond its scope or prior to its effective date should be considered taxable to an exempt organization." [21]

[21] Congressional Record, p. H8361 (September 25, 1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Aside from this, there is no indication whether Congress regards the DAV case as a correct interpretation of prior law, insofar as it is not modified by the 1986 statutory change.

2. Distribution of Low-Cost Articles

The regulations, in §1.513-1(b), provide that the unrelated business income tax is inapplicable where an organization "sends out low-cost items incidental to the solicitation of charitable contributions." No definition of what will be considered a "low-cost item" for this purpose is provided. This issue was also addressed in the DAV case, *supra,* which found that the distribution of low cost items to donors there amounted to a trade or business where: (1) the activity was conducted in a commercial manner; and (2) the contributions required were not greatly in excess of the retail value of the distributed items.

Section 1601(a) of the Act amends §513 of the Code to provide, in subsection (h), some clarification of this rule. As amended by the Act, §513(h)(2) defines the term "low-cost article" for this purpose as one having a cost not in excess of $5 to the organization which distributes it (or on whose behalf it is distributed). This $5 amount is indexed for increases in the cost of living for taxable years beginning after 1987.

An aggregation rule is provided in §513(h)(2)(B); thus, if two or more items are distributed to a single distributee, they will be aggregated and treated as a single article for purposes of the $5 limitation on the "low-cost article" exception.

Note: This rule will require organizations which seek to rely on the $5 rule to maintain careful records as to the number of articles sent to each distributee, as well as the cost thereof.

A distribution of low-cost articles will qualify for the §513(h) exception only if: (1) the article is not distributed at the request of the distributee; (2) it is distributed without the express consent of the distributee; and (3) the articles in question are accompanied by both a request for contributions and a statement that the distributee may retain the item regardless of whether a charitable contribution is made.

3. Trade Show Income

Under pre-1986 TRA law, §513(d) of the Code provided an exemption from the unrelated business income tax for income derived by §501(c)(5) organizations (labor, agricultural or horticultural organizations) and §501(c)(6) organizations (trade associations) for income derived from qualified trade show and convention activities at which members of the sponsoring organizations sell products and services. The Act expands this exception in two ways. First, the expanded exception covers trade shows and conventions at which suppliers to the sponsoring organization's members (and not merely the members themselves) sell products or services related to the organization's exempt activities. *See* Conference Report, p. II-823. Second, qualified trade show and convention activities of charitable organizations and social welfare organizations (exempt under §501(c)(3) and (4), respectively) will be covered by the §513(d) trade show exemption.

In the Tax Reform Act of 1976, the Code was amended to provide that the tax on unrelated business income would not apply to qualified convention and trade show activities, defined as including activities carried out by labor, agricultural, or horticultural organizations, or trade associations (§501(c)(5) and (6), respectively) under the following conditions: (1) an activity is conducted in conjunction with an international, national, state, regional, or local convention, annual meeting or show conducted by the organization; (2) one of the purposes of the organization in sponsoring the activity is promotion and stimulation of interest in and demand for the products and services of that industry in general; and (3) the show is designed to achieve that purpose through the character of the exhibits and the extent of the industry products displayed. *See* §513(d)(3)(B). Act §1602(a) adds an item to the list of permissible purposes — the education of persons in attendance regarding new developments or products and services related to the exempt activities of the sponsoring organization. In addition, the categories of organizations which may benefit from this exception are expanded by Act §1602(b) to include §501(c)(3) and §501(c)(4) organizations (charitable, educational, etc. organizations and social welfare organizations, respectively).

C. Effective Date

The rules described above are applicable to exchanges and rentals of member lists, and to distributions of low-cost articles, after October 22, 1986 (the date of enactment). Act §1601(b). Section 513(d), relating to trade shows, applies in its amended form to activities in taxable years beginning after October 22, 1986 (the date of enactment). Act §1602(c).

III. Estimated Tax Requirements

Section 6154 requires corporations to make quarterly payments of estimated income tax with respect to the corporate income tax imposed by 11, the corporate alternative capital gains tax imposed by §1201 and the tax imposed upon insurance companies under Subchapter L of the Code. Prior to the 1986 Act, neither an exempt organization incurring liability for the unrelated business income tax under §511, nor a private foundation incurring liability for the excise tax on investment income under §4940, was required to make estimated tax payments.

Section 1542(a) of the 1986 Act amends §6154 to require installment payments of estimated tax by organizations liable for the unrelated business income tax or the excise tax on private foundation investment income. This is accomplished by the creation of §6154(h), which provides that for purposes of §6154 (which imposes the obligation to make estimated tax payments) and §6655 (which imposes a penalty for failure to make such payments): (1) any organization subject to the unrelated business income tax, and any private foundation, is treated as a corporation subject to tax under §11; (2) any tax imposed by §511 or §4940 is treated as a tax imposed by §11; and (3) references in §§6154 and 6655 to "taxable income" are treated as including references to "unrelated business taxable income" or "net investment income," as the case may be.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The effect of this change is to require the affected organizations to begin making quarterly estimated tax payments, effective for taxable years beginning after 1986. Act §1542(b).

Comment: The legislative history states no rationale for this change, and it would seem to be prompted by a desire to increase revenue rather than any specific policy considerations.

Because the exempt organization estimated tax requirements are grafted into the existing corporate estimated tax rules, affected organizations will be able to avoid penalties under the same circumstances as taxable corporations. Thus, under the general rule of §6655(b), an organization paying 90% of its tax liability by the due date will not be subject to the penalty for underpayment of estimated tax.

In addition, the usual penalty exceptions are applicable. Accordingly, if an organization's actual payments equal the prior year's tax, or the tax based on the current year's rates but otherwise on the basis of the facts shown on the preceding year's return and the law applicable to the preceding year, or 90% of a tax on annualized income, no penalties will be due.[22] Likewise available would be the special exception in §6655(e) for payments due with respect to recurring seasonal income patterns; this exception might prove helpful in the case of exempt organizations who receive most of their unrelated business income from a trade show or other event which falls near the end of its taxable year. For further details, *see* Tarr, 1 T.M., *Estimated Tax*.

[22] *See* §6655(d)(1), (d)(2), and (d)(3), respectively.

IV. Definition of a Government Official for Private Foundation Purposes

Code §4941 imposes a penalty excise tax on certain acts of self-dealing between a private foundation and its "disqualified persons." In addition to substantial contributors, foundation managers, and related interests, certain government officials are also categorized as disqualified persons for this purpose. *See* §4946(c). The term "government official" is defined in §4946(c) as including certain specified categories of officials. Prior to the TRA §4946(c)(5) referred to state or local elective or appointive offices held by individuals receiving gross compensation at an annual rate of $15,000 or more. Section 1606 of the 1986 Act amends this definition to raise the compensation threshold from $15,000 to $20,000, effective for compensation received after December 31, 1985.

Note that the Act does not change a comparable compensation test in §4946(c)(4), which includes within the term "government official" an individual holding a position in the U.S. House of Representatives or Senate and receiving gross compensation at an annual rate of $15,000 or more. The Act does not change the $15,000 threshold in this provision.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 51

EXECUTIVE COMPENSATION ISSUES

Marilyn E. Nelson, Esq.
Donald B. Reynolds, Jr., Esq.
Stuart M. Lewis, Esq.
Diane J. Fuchs, Esq.
Taina E. Edlund, Esq.
Silverstein and Mullens
Washington, D.C.

I. New Provisions Affecting Fringe Benefits

A. Introduction

Gross income includes "all income from whatever source derived," including compensation for services.[1] This definition is broad enough to encompass any non-cash benefits conferred on an employee as a form of compensation.[2] In addition, for purposes of Social Security (FICA), Unemployment Insurance payroll taxes (FUTA), and income tax withholding, the Code defines wages as all remuneration for employment, including the value of non-cash remuneration.[3] The regulations issued pursuant to the employment tax laws indicate that the value of any non-cash compensation is to be determined by the excess of its fair market value over any amount paid for it by the recipient.[4]

As a result of a variety of exceptions that have been created over time, however, the treatment of in-kind compensation is governed not by a broad inclusion rule but by statutory provisions, regulations, and administrative rulings that create exclusions of certain fringe benefits from taxable income. For example, prior to the Tax Reform Act of 1984,[5] a number of fringe benefits had been statutorily excludable from an employee's gross income. Among these so-called "statutory" fringe benefits were (1) group-term life insurance (under $50,000); (2) accident or health benefits; (3) up to $5,000 of death benefits; (4) group legal services; (5) dependent care assistance; (6) certain benefits provided to members of the Armed Services; and (7) parsonage allowances.

In the 1984 Act, Congress expanded by statute the categories of excludable fringe benefits, addressing a large number of employee benefits provided in the form of tangible property, services, discounts and other types of non-cash compensation that had long been regarded by the business community as non-taxable income. The 1984 Act added §§132 and 117(d) to the Code to exclude from income certain fringe benefits that come within one of five categories: (1) no-additional-cost services, (2) qualified employee discounts, (3) working-condition fringes, (4) *de minimis* fringes, and (5) qualified tuition reductions.[6] These categories of fringe benefits are also excluded from employment taxes, income-tax withholding, and from the Social Security benefit base.[7] Some of the exclusions apply to benefits provided not only to the employee but also to the spouse and dependent children of an employee. Some apply to former employees who have separated from service for reasons of disability or retirement, and to their spouses and dependent children. Some apply to surviving spouses and children of deceased employees. In the case of many of the categories of fringe benefits, a nondiscrimination test is applied, which makes the exclusion unavailable to highly compensated employees, owners, or officers if the benefit is provided to such individuals on a discriminatory basis.

Thus, as a result of the 1984 Act, the receipt of any fringe benefit that does not qualify for specific exclusion is taxable to the recipient and includible in wages for employment tax purposes.[8] The inclusion amount is the excess of the fair market value of the benefit over the amount paid by the employee.[9]

B. Overview

Sections 1161-1168 and 1853 of the 1986 Tax Reform Act the statutory fringe benefits to (1) make adjustments to the nondiscrimination rules, (2) clarify provisions of the 1984 Act, (3) extend benefit programs scheduled to terminate, or change the ceilings on amounts excludable from taxable income, and (4) provide transitional rules. In addition, the Act lifts the moratorium on the exclusion of faculty housing benefits, in effect as a result of the 1984 Act, and limits expansion of the excludable military fringe benefits. Finally, the Act makes technical corrections affecting a number of the fringe benefits excludable under Code §§132, 125, and 117.

---

[1] Code §61.
[2] Regs. §1.61-1(a); *Comr. v. Smith*, 324 U.S. 177 (1945) (stock options as compensation).
[3] §§3121(a), 3306(b), 3401(a).
[4] Regs. §31.3401(a)-1(a)(4).
[5] P.L. 98-369 (hereinafter, the 1984 Act).
[6] 1984 Act §§531(a) and 532.
[7] 1984 Act §531(d).
[8] *See* Code §61(a)(1), which, as defined by the 1986 TRA, defines gross income specifically to include fringe benefits.
[9] *Supra*, footnote 3 and accompanying text.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

C. *Detailed Analysis*

1. *Changes in Statutory Fringe Benefits*

a. *Deductibility of Health Insurance Costs of Self-Employed Individuals*

(1) *Present Law*

Under present law, a self-employed individual, such as a sole proprietor or a partner, cannot deduct amounts paid for health or accident insurance for himself or herself. By contrast, an employee can exclude from income, under Code §106, the employer's contribution to a plan providing such benefits to the employee. The only deduction presently available to a self-employed individual is the itemized personal deduction of amounts paid during the taxable year for medical care of the taxpayer and the taxpayer's spouse and dependents, to the extent that the medical expenses exceed 5% of adjusted gross income.

(2) *1986 TRA Provisions*

Section 1161 of the Act amends Code §162, relating to trade or business expenses, by adding §162(m), which provides a deduction for 25% of the cost of health insurance coverage during the taxable year of a self-employed individual and the individual's spouse and dependents. The deduction may be used to calculate AGI, to the extent that the deduction does not exceed the individual's net earnings from self-employment. The individual (or spouse) must be ineligible to participate in any other health plan subsidized by an employer. The deduction for this benefit is subject to the nondiscrimination rules for health plans, and therefore the deduction is allowed only if the coverage is provided under one or more plans meeting the applicable nondiscrimination requirements of post-TRA §89. In effect, §162(m) treats the deduction as if the coverage were employer-provided.[10]

(3) *Effective Dates*

The provision is effective for taxable years beginning after December 31, 1986 and before January 1, 1990. To the extent that the §89 nondiscrimination rules do not apply to the first taxable year of this provision, §1161(b)(2) of the Act provides a transitional rule under Code §162(m)(2)(B) that substitutes any nondiscrimination requirements otherwise applicable.

b. *Educational Assistance Programs, Group Legal Plans, and Dependent Care Assistance Programs*

(1) *Present Law*

(a) *Educational Assistance Programs*

Under Code §127, amounts paid by an employer to provide educational assistance to an employee are includible in the employee's income, unless the cost of the benefit qualifies as a deductible job-related expense of the employee. To qualify, the education must either maintain or improve the skills required for the employee to perform the job or meet the employer's requirements imposed as a condition of employment. Further, the program may not discriminate in favor of highly compensated employees. An employee could exclude from income a maximum educational assistance benefit of $5,000 from a qualified plan. Code §127 expired for taxable years beginning after December 31, 1985.

(b) *Group Legal Services*

Code §120 provides that amounts contributed by an employer to a qualified group legal services plan for employees are excluded from the employee's gross income. Any services received by, or amounts paid to, an employee as reimbursement for the cost of that employee's legal services (or of the employee's spouse or dependents) are also excludable from the employee's income, provided that the plan meets the nondiscrimination test of Code §120(c)(3). Moreover, an organization that provides the legal services as part of the qualified plan is entitled to tax-exempt status under Code §501(c)(20). The provision for the exclusion for group legal services benefits and for the tax exemption expired for taxable years ending after December 31, 1985.

(c) *Dependent Care Assistance*

Under Code §129, amounts paid by an employer through a dependent care assistance program for care of an employee's dependents are excludable from the employee's income. The exclusion amount is limited to the amount of a single employee's earned income for the taxable year or, if the employee is married, to the lesser of the employee's earned income or the earned income of the employee's spouse. To qualify for the exclusion, the program must be a written plan, must benefit exclusively the employees, and must meet a nondiscrimination test. No automatic expiration date was set for this exclusion.

(2) *1986 TRA Provisions*

The Act retroactively extends for two years, through December 31, 1987, the exclusion for educational assistance programs, group legal services plans, and tax exemption for qualified group legal services organizations.[11] Thus, the exclusion for educational assistance programs will expire for tax years beginning after December 31, 1987, while the exclusion for group legal services plans will expire for tax years ending after that date. Section 1162 of the Act increases the cap on the exclusion for educational assistance from $5,000 to $5,250. The pre-1986 TRA nondiscrimination tests continue to apply, because the programs are scheduled to expire before the §89 nondiscrimination rules take effect. If the programs are extended after 1987, the §89 nondiscrimination standards will apply.[12]

Because of the two-year extension, §1162 of the Act provides a transitional rule that allows election of group legal services under a cafeteria plan in 1986. Under the rule, an employee may revoke an election to take cash or a qualified benefit other than group legal services and make a new election to take group legal services instead during 1986. This rule is limited to cafeteria plans that did not, under pre-1986 TRA law, allow employees to elect group legal services benefits for any period after December 31, 1985. The revocation and election must be made within 60

[10] Act §1161(a) enacting Code §162(m)(2)(B); H.R. Rep. 99-841, 99th Cong., 2d Sess., pp. II-538-9 (1986) ("Conference Report").

[11] Act §1162(a) and (b).

[12] Conference Report at p. II-508.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

days after the date of enactment (*i.e.*, before December 22, 1986). If the plan provided this benefit on August 16, 1986, however, the election is not available.[13]

Section 1163 of the Act imposes a $5,000 cap ($2,500 for a married person filing separately) on the exclusion for dependent care assistance.[14] Moreover, if the employer maintains an onsite child-care facility, the amount that may be excluded with respect to any dependent will be based on the individual's utilization and the value of services provided.[15] These provisions are effective for taxable years beginning after December 31, 1986.

According to Code §89(i)(2), as added by Act §1151(a), educational assistance programs, group legal plans, and dependent care assistance programs are statutory employee benefit plans only if employers elect to treat them as such. An election to do so will enable the employer to use the plans in order to satisfy the benefits test.[16]

2. Changes Affecting Campus Lodging

a. Pre-1986 TRA Law

Code §119 excludes from an employee's gross income the value of lodging provided by the employer if it is furnished for the convenience of the employer on the employer's business premises and the employee is required to accept the lodging as a condition of employment. Under pre-TRA law, the rental value of on-campus housing furnished to faculty or other employees by an educational institution does not qualify for the §119 exclusion.[17] Thus, the rental value of the housing (minus any amounts paid by the employee) is includible in the employee's gross income and constitutes wages for purposes of employment taxes and income tax withholding. In the 1984 Tax Reform Act, Congress placed a moratorium on the issuance of regulations before January 1, 1986 that would provide for inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of either the operating costs of furnishing the lodging or the rent received.[18]

b. 1986 TRA Provisions

Act §1164 amends Code §119 to provide that the value of qualified campus lodging shall be excluded from the gross income of the employee. For purposes of federal income taxation, the fair market value of use (on an annualized basis) of qualified campus lodging is treated as not greater than 5% of the appraised fair market value of the lodging.[19] The person furnishing the appraisal must be independent of the educational institution and qualified to make appraisals of housing.[20] As a further requirement for qualification, a nondiscrimination test applies: the lodging must be furnished to any employee of the educational institution (or to the employee's spouse or dependents), not only to faculty employees.[21]

Under a safe-harbor rule, if the employee pays rent for qualified campus lodging in an amount equal to or in excess of 5% of the appraised value of the lodging, no amount is included for the benefit in the employee's wage base.[22] If the employee pays less than the lesser of (1) 5% of the appraised value or (2) the average of rentals paid by nonemployees to the same institution during the same period for comparable lodging, the excess value is includible in the employee's wages.[23]

If an appraisal is found defective or if none is obtained, the fair rental value for tax purposes must be determined by taking into account the average of rentals paid by individuals other than employees to the institution for comparable housing during the year in question.[24]

c. Effective Dates

The exclusion provision of Code §119(d) applies for taxable years beginning after December 31, 1985. For prior taxable years, the conference agreement directs the Service to follow the safe-harbor valuation rule of the bill as if it had been in effect for prior years (except with respect to any amount of value of campus lodging that was treated by the taxpayer as wages or included in income when furnished) and to use local tax assessments of the property for the qualified appraised value of the lodging.[25]

4. Changes Affecting Military Fringe Benefits

a. Pre-1986 TRA Law

Under pre-1986 TRA law, a number of benefits provided to members of the Armed Forces and their families, such as housing, food allowances, commissary and exchange shopping privileges, and health services, are excludable from gross income.

b. 1986 TRA Provisions

Under §1168 of the Act, the rules for the tax treatment of military benefits are consolidated and set forth in one statutory provision, designated as Code §134.[26] The conferees believed that understanding and administration of such tax benefits for members of the Armed Services and their dependents would thereby be improved.[27] Moreover, by explicitly identifying the military benefits excluded from income, the conferees intended to clarify that any benefits not expressly excludable from gross income under §134 or under other statutory Code provisions will be included in gross income.[28]

Section 1168 of the Act provides generally that the exclusion for military benefits applies only to those allowances authorized by any law or regulation (other than the Internal Revenue Code) on September 9, 1986.[29] The

[13] Act §1162(c); Conference Report, p. II-542.
[14] Act §1163(a) amending Code §129(a); Conference Report at p. II-541. *See also* Conference Report at p. II-508 with respect to eligibility and benefits tests.
[15] Act §1163(b) adding Code §129(e)(8).
[16] Conference Report, p. II-508-09.
[17] *See* Conference Report, p. II-544.
[18] 1984 TRA §531(g).
[19] Conference Report, p. II-544.
[20] *Id.*
[21] *Id.* at II-545.
[22] *Id.*
[23] Act §1164(a) adding Code §119(d).
[24] Conference Report, p. II-545.
[25] *Id.* at II-545.
[26] Conference Report p. II-548.
[27] *Id.*
[28] *Id.*
[29] Act §1168(a) adding Code §134(b)(1)(B).

Conference Report contains an exhaustive list of such benefits excludable under the provision, but authorizes the Secretary of the Treasury to expand the list if a benefit was unintentionally omitted.[30] Otherwise, the number and nature of excludable military benefits are not to be modified or adjusted, except for cash benefits payable pursuant to a law or regulation in effect on September 9, 1986 or determined by reference to cost, price, or similar indices.[31]

c. Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

5. Changes Affecting the Employer's Deduction for Accrued Vacation Pay

a. Pre-1986 TRA Law

For deferred benefits, such as vacation pay earned by employees in one year but paid in a subsequent year, an accrual-basis employer generally may claim a deduction in its taxable year in which ends the taxable year of the employee for which the vacation pay vests or is paid. An exception applies to amounts paid within 2½ months after the close of the employer's taxable year in which the vacation pay is earned. Under pre-TRA law, a special rule of Code §463(a) allows an employer an election to deduct an amount that represents a reasonable addition to a reserve account for vacation pay, whether contingent or vested, earned by employees before the close of the current year and expected to be paid by the close of that year or within 12 months thereafter.[32]

b. 1986 TRA Provision

Section 1165 of the Act amends the special rule of Code §463(a) to limit the deduction to vacation pay actually paid during the current taxable year or within 8½ months after the close of the taxable year in which the vacation pay was earned by the employee.

c. Effective Date

This provision is effective for taxable years beginning after December 31, 1986.[33]

6. Changes Affecting Full-Time Life Insurance Salespersons

a. Pre-1986 TRA Law

Under pre-TRA law, a full-time life insurance salesperson was treated as an employee for purposes of eligibility for certain specific employee benefit exclusions enumerated in Code §7701(a)(20). The salesperson, however, is not treated as an employee for purposes of cafeteria plan provisions, under which an employee is offered a choice between cash and one or more employee benefits.[34]

b. 1986 TRA Provision

Section 1166 of the Act amends Code §7701(a)(20) to permit a full-time insurance salesperson to be treated as an employee for purposes of the cafeteria plan provisions (Code §125) to the extent the salesperson is otherwise permitted to exclude the value of the elected benefit from income.

c. Effective Date

The amendment is effective for years beginning after December 31, 1985.

7. Due Date for the Study of Welfare Benefit Plans

Section 560(b) of the Tax Reform Act of 1984 set the due date of February 1, 1985 for the completion of a study of welfare benefit plans. Section 1167 of the 1986 Act extends the due date to one year after the date of enactment: October 22, 1987.

8. Technical Corrections

a. The Line-of-Business Requirement

Code §132(a)(2) excludes from income certain employee discounts on property or services offered for sale to customers in the course of the line of business of the employer in which the employee is performing services. Section 1853(e) of the Act amends Code section 132(h)(2)(B) by clarifying that a leased section of a department store that offers beautician services and also makes sales of beauty aids in the ordinary course of business is to be treated as a part of the store operator's line of business. This treatment is to be available without requiring that a specified percentage of the beauty salon's revenue be earned through the sale of beauty products.

b. Working-Condition Fringe Benefits

(1) Automobile Product Testing

The conference agreement adopts that portion of the legislative history of the House bill which relates to an employee's personal use of an automobile as a working-condition fringe benefit, in the case of an automobile furnished for the purpose of product testing.[35] The Conference Report clarifies that, if the employer charges the employee a reasonable amount for any personal use of the automobile, the product-testing exclusion rule is not violated, provided that all of the other requirements for exclusion are satisfied. The charge will be sufficient if it exceeds the cost to the employer in making the product available to employees.[36]

(2) Definition of "Automobile Salesman"

The Conference Report clarifies that the exception to the working condition fringe benefit rule of Code §132(h)(3) for full-time automobile salesmen is not intended to be restricted to employees who have the formal title of "salesperson."[37] Rather, the term is intended to apply to full-time employees of an automobile dealer as floor salespersons or salesmanagers or who perform those functions as an integral part of their employment.[38]

[30] Conference Report, p. II-549.
[31] Code §134(b)(3)(A) and (B).
[32] *See* Conference Report, p. II-546-47.
[33] Act §1165(b).
[34] *See* Conference Report, p. II-542.
[35] H.R. Rep. 99-426, 99th Cong., 1st Sess., pp. 1000-1001 (1986). ("House Report").
[36] Conference Report, p. II-851.
[37] *Id.*, p. II-851.
[38] House Report at 1001.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

c. De Minimis Fringe Benefits

The Conference Report clarifies that, under the de minimis fringe benefit exclusion of Code §132(e), transportation provided by the employer includes tokens and reimbursements to cover the costs of commuting by public transit, provided that the amount of such reimbursement does not exceed $15 per month or $180 per year.[39]

d. Definition of Dependent Children

Exclusions from gross income for no-additional-cost services and certain other fringe benefits generally apply to employer-provided benefits for use by an employee, the employee's spouse, or the employee's dependent child. Section 1853(a)(1) of the Act amends Code §132(f)(2)(B) to define a dependent child as any child of the employee who is either (1) a dependent of the employee or (2) under age 25 with both parents deceased. The amendment is effective as if included in the provisions of the 1984 Act.

e. Definition of Customer

Under pre-TRA Code §132(i) the term "customers" for §132 purposes did not include employees, except for purposes of §132(c)(2)(B), which relates to the determination of the employer's gross profit percentage as a cap on the exclusion of qualified employee discounts. The exception did not apply, however, to Code §132(c)(2)(A), which defines "gross profit percentage." Section 1853(a)(3) of the Act amends Code §132(i) to correct the discrepancy by making the exception of §132(c)(2)(B) applicable to both paragraphs of §132(c)(2). The amendment is effective as if included in the provisions of the 1984 Act.

f. Clarification of Employee Discounts

Section 1853(a)(2) of the Act amends Code §132(c)(3)(A) to clarify that, for purposes of the qualified employee discount rules, merchandise for which employees pay a discounted price is that which the employer offers to the employee for use by the employee.

g. Excise Tax on Fringe Benefits

Section 1853(c) of the Act amends Code §4977 (election to treat multiple lines of business as a single line of business) to relax the line-of-business limitation applicable to Code §132 exclusions for no-additional-cost services and qualified employee discounts, which under pre-TRA law limits the determination of the employees as of January 1, 1984. Under the amendment, the class of employees entitled to employee discounts is expanded to include those entitled to discounts on or after January 1, 1984. Section 4977 is to apply only with respect to employment within the United States, except as otherwise provided in Treasury regulations.

h. Cafeteria Plans

Section 1853(b) of the Act amends Code §125 to clarify the benefits that may be provided under cafeteria plans. The amendment removes the language referring to "statutory nontaxable benefits" and substitutes "qualified benefits." The effects of the provision are to (1) eliminate the implication that a taxable benefit provided through a cafeteria plan is nontaxable and (2) clarify that certain taxable benefits may be provided in a cafeteria plan.

The amendment makes two changes to the transition relief provided to certain cafeteria plans under the 1984 Act. First, it provides that a cafeteria plan existing on February 10, 1984 and maintained pursuant to collective bargaining agreements will be granted relief under the transitional rules until the last collective bargaining agreement relating to the cafeteria plan expires. When a collective bargaining agreement terminates is determined without regard to any extension of the agreement agreed to after July 18, 1984. If a cafeteria plan is amended to conform with the requirements of the Act or of regulations, it is not treated as a termination of the collective bargaining agreement. Second, a cafeteria plan that suspended a type or amount of benefit after February 10, 1984, and subsequently reactivated it will be eligible for transition relief.[40]

i. Telephone Service for Pre-Divestiture Retirees

Section 1853(d) of the Act applies a transitional rule under which the fair market value of free telephone service provided by the Bell System to its employees who retired prior to divestiture is excluded from income under the no-additional-cost and line-of-business exclusions.[41] The provision applies to an employee who separated from service prior to January 1, 1984 by reason of retirement or disability of an entity subject to the modified final judgment (as defined in Code §559(c)(4)). The exclusion is available to officers, owners, or highly compensated employees only if the no-additional-cost service is available to employees on a nondiscriminatory basis.

j. Qualified Tuition Reduction

Section 1853(f) of the Act provides transitional rules for the treatment of certain tuition reductions under Code §117(d). Code §117(d) provides that the tuition reduction exclusion, generally available to an employee of an educational institution, is not allowed if the tuition reduction plan of the institution is discriminatory. The amendment provides three special rules. The first tests the tuition reduction program of Oberlin College for nondiscrimination.[42] The second rule provides that any tuition reduction for a full-time course of study at the graduate level before July 1, 1988 is excludable from gross income if it would have been excludable under regulations in effect on July 18, 1984 (the enactment date of the 1984 TRA) and the reduction is provided with respect to a student who was accepted for admission to the course of study before July 1, 1984 and who began it before June 30, 1985.[43] The final rule contained in Act §1853(f) provides that, in testing a tuition reduction plan for discrimination, employees covered under a collective bargaining agreement where such benefits have been the subject of good faith bargaining are not counted. This provision is effective as if enacted as part of the 1984 TRA.

[39] Conference Report at II-852, adopting the provision of the Senate Report at 1026.

[40] House Report at 1000.

[41] Conference Report at II-852, adopting the provisions of the House Report at 998-99.

[42] House Report at 1003.

[43] *Id.*

II. Stock Options (§321), Including Technical Corrections (§1855)

A. Introduction

When it enacted the Economic Recovery Tax Act of 1981, Congress re-established tax-favored stock options in the form of incentive stock options (ISOs). The earliest form of qualified options were "restricted stock options," which were first authorized by the Revenue Act of 1950. In 1963, Congress replaced the restricted stock option with a more limited form of option, the "qualified stock option." Subsequently, the Tax Reform Act of 1976 repealed qualified options as a tax-favored form of compensation.

In drafting Code §422A, which created incentive stock options, Congress drew heavily from the earlier rules applicable to restricted and qualified options. Consequently, many of the technical requirements that an option must satisfy to qualify as an ISO can be traced to the earlier Code provisions defining restricted stock options and qualified stock options.

The tax-favored status of ISOs results from the fact that the employee realizes no income upon receiving or exercising an ISO. Further, the employee's gain upon a sale of the shares acquired with an ISO has, prior to the 1986 TRA, been subject to tax at favorable capital gains rates, provided that (i) the employee did not transfer the stock within two years after the option was granted, and (ii) the employee held the stock for one year after option exercise before selling or otherwise disposing of it. In exchange for the favorable treatment afforded employees, §421 of the Code precluded an employer from claiming any deduction under §162 with respect to an ISO.

The tax treatment of ISOs contrasts with the treatment of nonqualified options. Such options are subject to §83, which applies generally to transfers of property in connection with the performance of services. Under these rules, an employee who receives a nonqualified option with an readily ascertainable fair market value realizes ordinary income, in the year of grant, equal to the value of option, less any consideration paid by the employee for the option. If a nonqualified option has no readily ascertainable fair market value at date of grant, the employee realizes ordinary income at the time he exercises the option (unless the acquired shares are subject to a substantial risk of forfeiture and are non-transferrable), equal to the difference between the value of the stock at the time of exercise and the option price. In addition, under §83(h), an employer that issues a nonqualified option generally can deduct, in the year the employee realizes income, an amount equal to the income taxed to the employee.

To qualify for the favorable tax treatment described above, an ISO and the plan under which it is granted must satisfy a number of technical requirements specified in §422A(b). Prior to the 1986 TRA, §422A(b) imposed a sequential exercise rule, which basically required that ISOs be exercised in the same order in which they were granted to the employee. Section 422A(b) also imposed a $100,000 ceiling on the amount of options that could be granted to an employee in any one year. That is, the plan was required to state that no employee could be granted, in any calendar year, options to purchase more than $100,000 of stock (the valued being determined at the time of grant), plus any available portion of the employee's "unused limit carryover."

Because Congress concluded that the sequential exercise rule and the $100,000 annual limitation unduly restricted the ability of employers to utilize ISOs, it repealed the sequential exercise rule and liberalized the annual ceiling on the amount of options that may be granted. Congress felt that these two restrictions hampered the ability of small employers and start-up companies to use ISOs as a means of attracting and motivating key employees. In enacting §422A in 1981, Congress intended that such companies should be able to use ISOs to better enable them to compete with larger employers for key employees.

B. Overview

The 1986 TRA included several amendments to the rules governing incentive stock options. Specifically, the Act amended §422A(b) by repealing the sequential exercise rule and liberalizing the annual $100,000 limitation. Further, the 1986 TRA made several technical corrections to the incentive stock option provisions contained in §555 of the Tax Reform Act of 1984.

The most significant change in TRA 1986 affecting ISOs, however, most certainly will result from the change in tax rates. The adoption of a single maximum individual tax rate of 28% (without any capital gains differential) should reduce the attractiveness of ISOs when compared to other forms of compensation. Moreover, the post-TRA 34% corporate rate will require employers to evaluate ISOs in a materially different way.

C. Detailed Analysis

1. Amendments to §422A

a. Sequential Exercise Rule

The 1986 TRA (§331(a)) repealed the sequential exercise rule of §422A(b)(7). This rule required that an ISO, by its terms, could not be exercisable while there was outstanding any other ISO granted to the optionee on an earlier date by his employer corporation or its parent or subsidiary. The effect of this rule was to require that incentive options be exercised in the order in which they were granted. Further, §422A(c)(7) provided that, for purposes of the sequential exercise rule, an ISO was treated as outstanding until it was exercised in full or expired by reason of the lapse of time. Thus, where an earlier option "blocked" the exercise of a later option, the cancellation of the earlier option before its expiration date would not enable the employee to exercise the later option any sooner because the earlier option was deemed to be outstanding until the date on which it would have expired. This provision was repealed by Act §331(b). The rules applicable to "qualified stock options" contained a slightly different variation of the sequential exercise rule.[44]

Congress originally imposed the sequential exercise rule upon qualified options to prevent the perceived abuse of employers' resetting option prices in a falling market.[45]

[44] *See* §§422(b)(5), 422(c)(6).

[45] *See* H.R. Rep. No. 749, 88th Cong., 1st Sess. 65 (1963).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The legislative history of the 1986 TRA suggests that Congress believed that companies that have experienced a decline in their stock prices were effectively precluded from using incentive options as a viable method of compensation.[46] Thus, under amended §422A, an employee may choose to exercise his ISOs with the lowest exercise price without regard to the date of grant of any of the options.

By repealing the sequential exercise rule, Congress removed one of the less obvious traps contained in §422A. Under the prior rules, if an employer modified an ISO but did not extend the option term, the "shadow rule" could prevent the employee from exercising the modified ISO since the employee was deemed to hold two options, the original option and the modified one. If the term of the modified option was not extended beyond the term of the original one, the original option could block the exercise of the modified option since the two options could be viewed as expiring at the same time.[47]

b. Annual Limitation on Amount of ISOs

The 1986 TRA liberalized the annual limitation in §422A(b)(8) on the amount of ISOs that an employer may issue to individual employees. Under §422A as originally enacted, an employee could not receive, in any calendar year, options to purchase more than $100,000 of stock (the value of such stock being determined at the time of grant), plus any available portion of a carryover amount. The carryover amount equaled one-half of the difference between $100,000 and the value of stock for which the employee was granted options under his employer's ISO plan (or under the ISO plan of the employer's parent or subsidiary) in a post-1980 year.[48] The statute allowed an unused carryover amount to be carried forward for three successive years. Further, the options granted to an employee in any year were treated as first counting toward the $100,000 ceiling for that particular year and then using up the carryovers in chronological order. That is, after the annual $100,000 amount was reached, the carryovers were then consumed, with the current year's options being allocated to the oldest carryover first.

Because Congress believed that the original form of the $100,000 limitation unduly restricted start-up companies in their ability to attract key employees, it modified the ceiling on the amount of stock for which an employee may be granted incentive options in any one year.[49] Consequently, under §422A(b)(7), as amended by Act §331(a) all ISO plans must provide that the aggregate fair market value (determined at the time of grant) of the stock *exercisable for the first time by an employee during any calendar year* shall not exceed $100,000. The amended Code section, however, repeals the concept of an unused limit carryover.

The modified ceiling represents a material liberalization of the incentive option rules. Under pre-1986 TRA §422A(b)(8), an employer could issue only $100,000 of options (plus any unused carryovers) to an employee each year. Under the post-TRA rules, the amount of options which may be granted is substantially greater in that an employer may issue, in a particular year, options to purchase up to $100,000 of stock in each of a number of future years (provided that no options had previously been issued which first become exercisable in any of such future years). Consequently, because ISOs may be exercisable for up to 10 years from the date of their grant, employers will be able to offer a key employee an increased amount of options immediately upon hiring the employee.

Example: An employer with an ISO plan hires a new employee in 1987 who is eligible to participate in the plan. The employer may immediately grant the employee, for example, five options, each of which entitles the employee to purchase $100,000 of the employer's stock, provided the vesting schedule for the options is such that options for no more than $100,000 of stock become exercisable in any one future year. Moreover, to the extent that the employee receives options for less than $100,000 of stock that are first exercisable in any particular future year, the employer may subsequently grant additional options that first become exercisable in that same future year.

c. Effective Dates and Plan Amendments

The two amendments to §422A described above apply to ISOs granted after December 31, 1986.[50] Although presumably all employers and employees will benefit from the repeal of the sequential exercise rule, it is not mandatory that existing plans be amended to delete this restriction because plans may incorporate provisions that are stricter than, but not inconsistent with, the requirements of §422A(b). Because the amendments are not applicable to options granted before January 1, 1987, it is not possible to amend options granted before this date to delete the sequential exercise requirement.

In contrast to the amendment repealing the sequential exercise rule, it appears that the modification to the annual ceiling on options will require an amendment to existing plans if the plan sponsor wishes to continue to grant ISOs after 1986. Post-1986 TRA §422A(b)(7) requires that the annual limitation be imposed "under the terms of the plan." Moreover, in certain circumstances a plan that contained only the pre-TRA annual limitation could permit an employee to receive an amount of options that exceeds the TRA-imposed restriction. For example, under the post-TRA rule, once an employee receives an option for $100,000 of stock that is first exercisable in, 1990, he may not be granted any additional options that first become exercisable in 1990. In the foregoing example, however, the pre-TRA annual limitation would permit the employer to grant up to $100,000 of options in each subsequent calendar year regardless of whether the additional options first became exercisable in 1990 or some other year. Given this potential incongruity between the two versions of the annual ceiling, an employer would be well-advised to incorporate the post-TRA version of §422A(b)(7) in its ISO plan if there is any possibility that ISOs will be granted under the plan after 1986.

If an employer fails to incorporate the TRA amendments into its ISO plan and continues to grant ISOs after

[46] *See* S. Rep. No. 313, 99th Cong., 2d Sess. 171 (1986).
[47] *See* Regs. §1.422A-2(f)(4), Example (6).
[48] Code §422A(c)(4).
[49] *See* S. Rep. No. 313, 99th Cong., 2d Sess. 171 (1986).
[50] Act §321(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

1986, certain problems may be experienced because of the restrictions in §425(h). Section 425(h) provides that if an option is modified, the modification is considered the granting of a new option, and the "new" option must meet all of the requirements of §422A(b) as of the date of the modification, including the requirement that the option price equal the fair market value of the stock on the date of grant.[51] If an employer were to grant an option after 1986 that, by its terms, contained the sequential exercise rule, the employer and the employee would apparently be limited in their ability to amend the option to delete the restriction. Such an amendment presumably would result in a modification of the option because it would give the employee "additional benefits under the option." [52] The deemed "new" option would be required to have an option price equal to the fair market value of the stock on the modification date. Thus, if the stock had appreciated after the original date of grant, the employer would be required to reset the option price at the higher, current value.[53]

2. Technical Corrections

The Tax Reform Act of 1984 amended §422A to provide that, for purposes of determining whether the fair market value of stock equals the option price (as required by §422A(b)(4)), stock must be valued without regard to any restriction other than a restriction which, by its terms, will never lapse. The 1984 Act also added a parallel provision to §57(a)(10) to provide that, under the alternative minimum tax, the item of tax preference arising from the exercise of an ISO must be calculated by determining the value of the stock without regard to restrictions that will lapse in the future. The effective dates for these changes, which were contained in §555(c) of the 1984 Act, included several erroneous cross references to the substantive provisions enacted by §555(a) and 555(b). The 1986 TRA corrected these cross reference errors. In addition, the 1986 TRA clarified the application of a transitional rule incorporated in §555(c)(2) of the 1984 Act. Specifically, as modified by the 1986 TRA, the minimum tax rule described above generally applies to options exercised after March 20, 1984. In the case of an option issued pursuant to a plan adopted by an employer before May 15, 1984, however, the minimum tax rule applies only to options issued after December 31, 1984.

3. Tax Rate Changes

Although the amendments to §422A described above in III, A, *supra*, modify and liberalize two important rules governing the qualification of ISOs, the most significant effect of the 1986 TRA on incentive options may result from the reduced tax rates enacted by the statute. As discussed *infra*, it appears likely that the TRA's reduced rate structure will materially reduce the attractiveness of ISOs. Consequently, although Congress indicated its intention, by liberalizing certain rules in §422A, to make ISOs a more viable means of compensating employees, other more fundamental changes effected by the 1986 TRA will, in all likelihood, limit the degree to which employers use ISOs as a means of compensating key employees.

When the TRA rates are fully effective in 1988, individuals will be subject to a maximum tax rate of 28%, applicable to all of their income regardless of its characterization as compensation or capital gains. Under pre-TRA law, one of the primary benefits of ISOs to employees resulted from the capital gains rate differential. That is, under §422(a), an employee realized no income either upon receiving an ISO or upon exercising it. (The difference between the option price and the value of the shares on the exercise date, however, constituted a preference item for purposes of the minimum tax under §57(a)(10).) Further, assuming that the employee satisfied the holding period requirements, his gain on the ultimate sale of the shares would be taxed at the preferential capital gain rate. Given the differential between the maximum capital gain rate (20%) and the maximum rate applicable to compensation (50%), ISOs often were more attractive to employees than nonqualified options and other alternative forms of compensation that were subject to tax under §83 at ordinary income rates.

Because all income is subject to the single maximum rate of 28% once the TRA is phased in, from an employee's perspective, the attractiveness of an ISO may diminish significantly when compared to a nonqualified option. Under §83, an employee who receives a nonqualified option generally will realize income in the year of exercise equal to the difference between the exercise price and the value of the shares acquired. Under the 1986 TRA rates, this income would be subject to tax at the 28% rate, as would the gain on the ultimate sale of the stock. In contrast, under the 1986 TRA, the issuance and exercise of an ISO would continue to create no taxable income (other than as a tax preference item under §57(a)(3) of the revised minimum tax), and the gain on the ultimate sale of the stock (*i.e.*, the difference between the employee's cost basis in the shares and the sales proceeds) would be taxed at a maximum rate of 28%. Thus, the gain arising from both an ISO and a nonqualified option is taxed at the same rate.

It appears that, notwithstanding the uniform 28% rate, ISOs may continue to have some appeal because of the deferral element created by §422(a), if quick resale of the optioned shares is not contemplated.

Note: In the year of exercise, the bargain element of an ISO will continue to constitute a tax preference item under the alternative minimum tax. If the employee incurs minimum tax in the year of exercise, however, under post-TRA §53, he should qualify for the credit for prior year minimum tax liability in the first future year he has regular tax liability.

From the employer's perspective, the maximum corporate tax rate of 34% enacted by the 1986 TRA will modify the analysis that must be made when comparing ISOs to forms of nonqualified deferred compensation. Under Code §421(a)(2), the employer is entitled to no deductions with respect to ISOs granted to employees or the stock issued upon the exercise of ISOs. In contrast, under §83(h), upon an employee's exercise of a nonqualified option, the employ-

[51] Code §422A(b)(4).

[52] *See* Code §425(h)(3); Rev. Rul. 74-546, 1974-2 C.B. 142.

[53] In the example in the text, because the employer granted the ISO after 1986, the option was subject to the TRA 1986 amendments, which abolished the sequential exercise rule. Consequently, the modification would not create a "shadow" option that could serve to block the exercise of the deemed new option. *See* III, A, 1, *supra*.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

er generally may deduct an amount equal to the income realized by the employee with respect to the bargain element of the option. Given the availability of a deduction for nonqualified options and the post-TRA differential between the corporate and individual maximum rates, ISOs generally will become a less attractive form of compensation from the employer's perspective. Indeed, because the maximum corporate rate exceeds the maximum individual rate, it would appear that, in many cases, nonqualified deferred compensation could be structured to the advantage of both the employer and the employee. That is, in a simple case, an employer might gross up the nonqualified compensation payable to an employee to reimburse the employee for the 28% maximum tax rate. Inasmuch as the compensation would be deductible to the employer at a rate of up to 34% the value of the deduction to the employer may exceed the additional amount it must compensate the employee to make him whole. Thus, in the case described above, both the employer and the employee may prefer nonqualified compensation, such as nonqualified options, over ISOs.

Although the above analysis suggests that many employers may find nonqualified deferred compensation more attractive than ISOs, it is not clear that existing incentive options should be converted into nonqualified options. For example, if individual rates were to increase in the future and Congress were to reinstitute a capital gains rate differential, the benefits that have historically been available for ISOs and other qualified options presumably would reappear. Given this possibility, employers may choose to continue to maintain existing ISO plans and not tamper with outstanding ISOs until there is some further indication that the repeal of the capital gains differential is a permanent fixture in the tax law.

III. Nonqualified Deferred Compensation and Section 457

A. Introduction

1. Section 457

Section 457 of the Internal Revenue Code, as it existed before the enactment of the Tax Reform Act of 1986, imposed special rules on deferred compensation arrangements provided for employees of state and local governments. These rules continue to apply but in modified form.

These rules generally limit the maximum amount that may be deferred under the plan for any taxable year to the lesser of $7,500 or 33⅓% of the participant's includable compensation, *i.e.*, compensation net of the deferral amount. Special catch-up rules are provided for the last three taxable years before the participant reaches normal retirement age under the plan. Amounts contributed to a tax-sheltered annuity under §403(b) are taken into account in calculating whether an employee's deferrals exceeded these limits. Failure to satisfy these rules results in inclusion in income currently of any amounts deferred under the plan.

Section 457 also prevents distributions from being made available to an employee before separation from service unless the employee has experienced an "unforeseeable emergency." If the employee experiences an unforeseeable emergency, the amount needed may be distributed.

2. Constructive Receipt

Under Code §451, amounts are generally taxable to an employee when received or when "made available." If an amount is made available but not actually received, it is taxable under the doctrine of constructive receipt.

On February 3, 1978, the Service issued Prop. Regs. §1.61-16, which provides that, if payment of an amount of a taxpayer's fixed basic or regular compensation is deferred, at the taxpayer's individual election to a taxable year later than that in which the amount would have been payable but for the election, then the amount is treated as received in the earlier taxable year. As a result of a provision in the Revenue Act of 1978, however, the scope of this proposed regulation was effectively limited to employers that are tax-exempt.[54] Even though proposed in 1978, Prop. Regs. §1.61-16 had not, at this writing, been finalized.

B. Overview

The major change that the Act makes in §457 is to extend those rules to any organization exempt from income taxes.[55] At the same time, §457 continues to apply to deferred compensation of states, political subdivisions of states and agencies and instrumentalities of states. Further, the Act extends the §401(a)(9) rules applicable to distributions from qualified plans to deferred compensation arrangements under §457. In addition, under §457(d), specific payout rules are provided for lifetime and post-death distributions. The Act also generally repeals the constructive receipt rule for distributions that do not exceed $3,500. *See* Code §457(e)(9).

In general, the changes to §457 apply taxable years beginning after December 31, 1988. The special rules that extend the rules of §457 to tax-exempt employers, however, are generally effective for taxable years beginning after December 31, 1986. Act §1107(c).

C. Detailed Analysis

1. Application to Tax-Exempt Employers

As revised by the Act, §457 applies to "eligible deferred compensation plans." [56] "Eligible deferred compensation plan" is defined to include plans established and maintained by an "eligible employer." [57] "Eligible employer" means a state, political subdivision of a state and any agency or instrumentality of a state or political subdivision of a state and any other organization (other than a governmental unit) exempt from tax under "this subtitle." [58] The reference in this definition to "this subtitle" is a reference to subtitle A of the Internal Revenue Code, which includes all of the organizations exempt from tax as a result of §501 of the Code.

As a result of the Act, some of the organizations that will be subject to the rules of §457 on deferred compensation include:

1. title-holding organizations exempt under §501(c)(2);

[54] *See* §132 of the Revenue Act of 1978.
[55] Act §1107.
[56] Code §457(a), as modified by §1107 of the Act.
[57] Code §457(b).
[58] Code §457(e).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

2. charitable, religious and educational organizations, including nongovernmental schools, private hospitals and private foundations that are exempt from tax under §501(c)(3);

3. labor unions exempt under §501(c)(5);

4. trade associations, business leagues and professional football leagues exempt under §501(c)(6);

5. private clubs exempt under §501(c)(7);

6. fraternal orders exempt under §501(c)(8);

7. farmers' cooperatives exempt under §521(a).[59]

The principal significance of treating tax-exempt organizations as "eligible employers" subject to §457 is to impose limits on the amount of deferred compensation that can be made available to employees of those organizations on a tax-deferred basis. In many cases, executives will find themselves subject to much lower limitations than their counterparts who work for taxable employers.

Of additional importance is the broad reach of §457. Because of the history of §457 (it was originally instituted as a result of questions about salary reduction arrangements entered into by employees) many commentators have failed to note that, as modified, §457 applies to both compensation deferred at the employee's election as well as other types of deferred compensation. That is, §457 is now applicable to all types of deferred compensation whether the employee makes the deferral through salary reduction or whether the employer initiates the deferral. Failure to satisfy the requirements of §457 would cause the employee to be taxable on the amount of the deferral at the time there is no longer a substantial risk of forfeiture with respect to the deferred compensation, even if it was not otherwise available to the employee. That is, the employee would be taxed under principles analogous to those in Code §83 so that whether the employee could have reached the money or not under general income tax principles is of no consequence.[60]

Note: Section 457 does not apply to qualified plans, tax-sheltered annuities under §403(b) and transfers of property taxed under §83 of the Code.

Example: Employee A is hired by a tax-exempt trade association beginning in 1987. As remuneration for his services, Employee A will be paid annual compensation at the rate of $80,000 per year and, in addition, will have $10,000 deferred until termination of employment pursuant to a nonqualified deferred compensation arrangement. This deferred compensation arrangement was entered into at the insistence of the employer, who could not currently afford the remuneration requested by the employee. Since this arrangement does not satisfy the requirements of §457 (the amount exceeds the limits on includable compensation under §457(b)(2)) and because the amount is not subject to a substantial risk of forfeiture, the full $10,000 will be taxable to the employee in 1987.

2. Distribution Requirements

The Act makes several changes in the distribution requirements applicable to deferred compensation plans under §457. First, it requires that the plan meet the requirements of §401(a)(9) of the Code, which are generally applicable to qualified plans.[61] Under §401(a)(9), distributions are generally required to commence no later than April 1 of the year following the year in which the individual reaches age 70½ (the required beginning date). Further, §401(a)(9) contains specific rules regarding the method and form of distribution to participants and beneficiaries.

Second, for lifetime distributions, §457 requires that the distribution must be made under a form under which at least two-thirds of the total amount payable for the participant will be paid during the life expectancy of the participant, determined at the time the distribution begins, and any amount not distributed to the participant during life will be distributed after death at least as rapidly as the method that was being used during the life of the participant.

Third, in the case of distributions which do not begin until after the participant's death, the entire amount payable with respect to the participant must be paid during a period that does not exceed 15 years or, if the beneficiary is the surviving spouse, the life expectancy of such spouse. Distributions payable over a period of more than one year, whether during life or after death, must be made in a form in which the payments are made no less frequently than annually and do not substantially increase in amount.

Fourth, if the total amount payable to the participant does not exceed $3,500 and no additional amounts may be deferred by the participant under the plan, then the participant will not be taxed under the doctrine of constructive receipt merely because the participant could have elected to receive a lump-sum payable within 60 days of the election. Thus, in the case of amounts under $3,500, the participant can be given an election to receive a lump-sum without causing the participant to be taxable under the doctrine of constructive receipt. Larger amounts, however, would not have this special statutory protection.[62]

Fifth, while the Act does not expressly permit rollovers from a §457 plan, it does permit direct transfers between plans covered by §457 without adverse taxation to the participant. Thus, a participant may direct the "eligible deferred compensation plan" of one employer to transfer amounts to an "eligible deferred compensation plan" of his new employer and the employee will not be taxed. If, however, the employee receives the distribution at any time, the employee would be subject to income tax as a result of that receipt.[63]

3. Effective Date

The general effective date for §1107 of the Act, which contains §457 as modified, is for taxable years beginning

[59] Clde §521(a) does not provide a complete exemption for farmers' cooperatives but because of explicit language in §521(a) and the lack of any special exceptions in §457, it would appear that farmers' cooperatives are covered by these 1986 TRA provisions as well.

[60] Code §457(f).

[61] Code §457(d)(2)(A).

[62] Code §457(e)(9).

[63] Code §457(e)(10).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

after December 31, 1988.[64] Special effective dates, however, are provided for certain changes made by the Act.

The rules cash-outs and transfers of interests in a plan covered by §457, as contained in §457(e)(9) and §457(e)(10), apply to taxable years beginning after December 31, 1986.

Second, §457 applies to eligible deferred compensation plans established and maintained by tax-exempt organizations for taxable years beginning after December 31, 1986. Under special transition rules, §457 will not, however, apply to amounts deferred under such a plan if the amount was deferred from a taxable year beginning before January 1, 1987 or the amount was deferred from a taxable year beginning after December 31, 1986 pursuant to an agreement which was in writing on August 16, 1986 and on such date provided for a deferral for each taxable year covered by the agreement of a fixed amount or of an amount determined pursuant to a fixed formula. Any modification of the amount or formula will cause a loss of this grandfather protection. Further, any amounts deferred pursuant to the grandfather clause for deferrals for taxable years beginning before January 1, 1987 are taken into account in applying §457 to other amounts deferred under any eligible deferred compensation plan.[65]

Two special rules are also provided. First, the amendments to §457 do not apply to any qualified state judicial plan defined in §131(c)(3)(B) of the Revenue Act of 1978 as amended by §6252 of the Tax Equity and Fiscal Responsibility Act of 1982.[66] Second, the amendments do not apply to any employees on August 16, 1986, of either a deferred compensation plan which a nonprofit corporation organized under the laws of the State of Alabama with respect to which the Service issued a ruling dated March 17, 1976 that the plan would not affect the tax-exempt status of the organization or a deferred compensation plan with respect to which a letter dated November 6, 1975 submitted the original plan to the Internal Revenue Service with an amendment submitted on November 19, 1975 and the Internal Revenue Service responded with a letter dated December 24, 1985, but only with respect to deferrals under such plan.[67]

IV. Golden Parachutes (Technical Corrections)

A. Introduction

The Tax Reform Act of 1984 added Code §280G, designed to discourage "golden parachute" arrangements under which excessive severance payments are made to corporate executives at the time of a corporate takeover or a change in ownership or control. The section imposes a nondeductible 20% excise tax on the recipient of excess parachute payments and denies a deduction to the employer for excess parachute payments.

Parachute payments are payments in the nature of compensation to a disqualified individual where the payment is contingent on a change in ownership or control and the value of the payment equals or exceeds three times a base amount. The base amount is an average of the compensation paid to the individual during the five taxable years ending before the date on which the change in ownership or control occurs. Compensation included to determine the average amount includes compensation that was paid by the corporation with respect to which the change in ownership or control occurs and which was includable in the gross income of the disqualified individuals for the five previous taxable years. A parachute payment is also defined to include any payment in the nature of compensation to disqualified individual if the payment is made pursuant to an agreement which violates securities laws or regulations.

Excess parachute payments are parachute payments in excess of the base amount that are not reasonable compensation for personal services actually rendered by the disqualified individual. Under prior law, the taxpayer had the burden of establishing, by clear and convincing evidence, that a parachute payment is reasonable compensation for personal services actually rendered (or to be rendered). To the extent a taxpayer establishes that the payment involved is reasonable compensation for personal services, the payment involved is first applied against the base amount.

Disqualified individuals are defined as an individual who is an employee, independent contractor, or other person specified in regulations who performs personal services for any corporation and is an officer, shareholder, or highly compensated individual. (A personal service corporation or similar entity is treated as an individual for these purposes.)

The golden parachute provisions were effective for payments made under contracts entered into or renewed after June 14, 1984. The provisions are also effective for all payments made under a contract entered into before June 15, 1984, if, after June 14, 1984, the contract is amended or supplemented in significant, relevant respect. A contract generally is treated as amended or supplemented if it is amended or supplemented to add or modify, to the executive's benefit, a change in ownership or control trigger, to increase amounts payable (or, if payment is to be made under a formula, to modify the formula to the executives' advantage) in the event of such a trigger, or to accelerate the payment of amounts otherwise payable at a later date in the event of such a trigger.[68]

The golden parachute rules were criticized by the Tax Bar and opposed by Treasury as an unnecessary incursion by the federal tax laws into an area more effectively addressed by either federal securities laws or state law limitations on corporate waste. In the two years following the enactment of the provision, the forecast of many practitioners concerning the harsh impact of the golden parachute rules due to their overencompassing nature, have proved to be accurate. The harshest impact of the rules appears to be in the area of smaller, in some cases closely-held, corporations, which are sold or merged in the normal course of business and do not fit into the stereotype of the hostile takeover models that were of concern at the time the provision was enacted.

[64] Act §1107(c)(1).
[65] Act §1107(c)(3).
[66] Act §1107(c)(4).
[67] Act §1107(c)(5).

[68] *See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Blue Book), pages 206-207.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The technical corrections to Code §280G are, by and large, substantive changes designed to limit the application of the section and to narrow its scope.

The Conference Report does not discuss the changes except to reference the Senate amendment and to indicate that the Conference agreement follows the Senate amendment. Since the Conference agreement contains no discussion of the provisions, it is intended that the Senate report serve as the legislative history for the changes.

B. Overview

As part of its technical corrections to the Tax Reform Act of 1984, the 1986 Tax Reform Act modified the rules concerning golden parachute payments in Code §280G in several respects:

First, and perhaps most significant, the 1986 TRA provides an exemption from the golden parachute rules for payments made on account of a change in ownership or control if the company making the payment is a small business corporation or a corporation the stock of which is not readily tradeable on an established securities market, provided certain criteria are satisfied.[69]

Second, the Act clarifies that an amount that can be established as reasonable compensation does not enter into the computation of whether the threshold for establishing a parachute payment is met, nor is it included in calculating the amount of the actual parachute payment.[70]

Third, the Act narrows the scope of what constitutes a parachute payment by excluding from includable compensation distributions from qualified plans.[71]

Fourth, it requires that affiliated groups of corporations be treated as one corporation for purposes of evaluating the application of the golden parachute rules.[72]

Fifth, it limits the number of highly compensated employees of any one corporation to 250.[73]

Last, it clarifies that only agreements that violate *generally enforced* securities laws, rather than *any* securities laws, will be parachute payments and it places the burden on the Service to establish that there is a violation of such securities laws.[74]

Since these amendments are in the nature of technical corrections to the 1984 Tax Reform Act, they are effective as if enacted as part of the 1984 Act.[75]

C. Detailed Analysis

1. Exemption for Small Business Corporations

The Act amends §280G(b) (defining excess parachute payment) by adding a new paragraph providing an exemption for small business corporations.[76] The exemption excludes from the definition of parachute payment any payment to a disqualified individual by a corporation which, immediately before the change in ownership or control, was a small business corporation as defined in §1361(b). Also excluded, is any payment to a disqualified individual from a corporation (other than a small business corporation) if, immediately before the change in ownership or control, the stock of the corporation was not readily tradeable on an established securities market or otherwise and certain shareholder approval requirements are met with respect to the payment.[77]

A corporation qualifies as a small business corporation if the corporation does not have more than 35 shareholders, have a shareholder who is not an individual (other than an estate or qualifying trust), have a non-resident alien as a shareholder, and have more than one class of stock.[78]

With regard to the exception for corporation with no readily tradeable securities, the statute requires that the following shareholder approval requirements be satisfied. First, the parachute payment must be approved by a vote of those who owned, immediately before the change in ownership or control, more than 75% of the voting power of all outstanding stock of the corporation and all of the shareholders must receive adequate disclosure of all material facts concerning the payment which, but for this exemption, would be parachute payments with respect to a disqualified individual.

The statute also authorizes the Secretary to issue regulations that provide that a company will not be treated as one which has its stock readily tradeable on an established securities market where a substantial portion of the assets of the entity consists (directly or indirectly) of stock in such corporation and interests in such other entity are readily tradeable on an established securities market or otherwise. Thus, if a publicly traded corporation sells the stock of a 70% subsidiary and the assets of the subsidiary constitute a substantial portion of the assets of the parent, the legislative history indicates that the exemption for a corporation with no readily tradeable securities will not be available with respect to payments to disqualified individuals on account of the change in ownership or control of the subsidiary.[79]

The legislative history further indicates a concern that, absent specific rules, a taxpayer might utilize the exemption for shareholder approval to avoid the golden parachute provisions by creating tiers of entities. As a result, the legislative history provides that, where the gross value of the entity-shareholders' interest in the corporation constitutes a substantial portion of such entity's assets, the Secretary will adopt regulations requiring approval of the owners of the entity rather than the approval of the entity itself. Further, such shareholder approval may be obtained only if the entity- shareholder also has no stock that is readily tradeable.[80] On the other hand, the approval of the compensation arrangement by an authorized officer of the entity will be sufficient if the entity's interest in the corpo-

[69] Act §1804(j)(1). Code §280G(b)(5).
[70] Act §1804(j)(2). Code §280G(b)(4).
[71] Act §1804(j)(3). Code §280G(b)(6).
[72] Act §1804(j)(4). Code §280G(d)(5).
[73] Act §1804(j)(5). Code §280G(c).
[74] Act §1804(j)(7). Code §280G(b)(2)(B).
[75] *See* Tax Reform Act of 1984, §67(e).
[76] Act §1804(j)(1) adding Code §280G(b)(5).
[77] Act §1804(j)(i); amending Code §280G(b)(5)(A)(i)-(ii).
[78] Code §1361(b).
[79] Senate Report, p. 918.
[80] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ration constitutes less than a substantial portion of its assets, because the golden parachute provisions, in general, do not apply to the sale of less than a substantial portion of the assets of a corporation.

The Senate Report sets forth the requirements that must be satisfied to demonstrate shareholder approval. First, the payment must be approved by a separate vote of the shareholders who, immediately before the change in ownership or control, hold more than 75% of the voting power of all outstanding stock of the corporation, and (2) adequate disclosure must be made to all shareholders of the material facts concerning payments that, absent the exemption, would be parachute payments. Adequate disclosure includes full and truthful disclosure of the material facts and such additional information as may be necessary to make the disclosure not materially misleading. The Senate Report also states that an omitted fact will be considered material if there is a substantial likelihood that a reasonable shareholder would consider it important.[81]

The Senate Report provides that, in applying the shareholder approval test, shareholders who receive payments that would otherwise be parachute payments, absent shareholder approval, are not to be included for purposes of determining whether there is shareholder approval. Further, a shareholder who is related to the disqualified individual is also removed from the shareholder base. If all shareholders are disqualified individuals or related to disqualified individuals, however, disqualified individuals are not to be removed from the shareholder base. The test for relatedness is to be made under the principles of §318.[82]

2. Reasonable Compensation

Act §1804(j)(2) amends §280G(b)(4) by clarifying that in the case of parachute payments contingent on a change in ownership or control as set forth in Code §280G(b)(2)(A), the amount treated as a parachute payment shall not include the portion of the payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered on or after the date of the change in ownership or control. Thus, in the case of a payment that is made on account of a change in ownership or control, the amount treated as a parachute payment will not include the portion of the payment that the taxpayer establishes is reasonable compensation for personal services in the future. Further, such payments are not taken into account in determining whether the threshold (*i.e.*, three times the base amount) contained in the definition of parachute payments is exceeded.

The Senate Report provides an example of a specific instance in which compensation may be treated as reasonable compensation for services. In the case of payments to an individual as damages for a breach of contract, where the employer fires an employee before the end of the contract term and the employee collects as damages for salary and other compensation, the amount collected may be treated as reasonable compensation for services to be rendered if (1) the damages do not exceed the compensation the individual would have received if the individual continued to perform services for the employer; (2) the individual demonstrates by clear and convincing evidence that the payments were received because an offer to work was made and rejected; and (3) any damages were reduced by mitigation.[83] The Senate Report cautions, however, that if damages are collected for a failure to make severance payments, damages collected would not be for personal services because the individual does not have to demonstrate a willingness to work and reduce any damages by mitigation.[84]

The Senate Report also states that evidence that amounts paid to a disqualified individual for services that are not significantly greater than amounts for compensation (other than compensation contingent on a change in ownership or control or termination of employment) paid to the disqualified individual in prior years or customarily paid to similarly situated employees by the same employer or comparable employers will normally serve as clear and convincing evidence that the amount constituted reasonable compensation for such services.

As under pre-1986 TRA law, the amount treated as an excess parachute payment is reduced by the portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the change in control. For purposes of this provision, however, again as under pre-TRA law, reasonable compensation for services performed before the date of the change is first offset against the base amount.

3. Exemption For Payments Under Qualified Plans

The Act provides that the term "parachute payment" does not include any payment to or from (1) a plan that is qualified under §401(a); (2) an annuity described in §403(a); or (3) a simplified employee pension as defined in §408(k).[85] Payments from qualified plans are also not taken into account in determining whether the threshold for excess parachute payments is exceeded.[86]

4. Treatment of Affiliated Groups

The statute provides that all members of the same affiliated group (as defined in §1504, determined without regard to §1504(b)) are to be treated as one corporation for purposes of the golden parachute rules. Further, any person who is an officer or any member of such group will be treated as an officer of such one corporation.[87]

The Senate Report indicates that, in addition to the general definition of an affiliated group, for this purpose an affiliated group of corporations also includes tax-exempt corporations; insurance companies; foreign corporations (unless the disqualified individual is employed by a foreign corporation that is acquired by another foreign corporation, neither of which is subject to tax in the United States); corporations with respect to which possession tax credit

[81] Senate Report, p. 919.
[82] *Id.*
[83] *Id.*
[84] *Id.*
[85] Act §1804(j)(3), adding Code §280G(b)(6).
[86] Act §1805(j)(6) amending Code §280G(b)(2)(A).
[87] Act §1805(j)(4) adding Code §280G(d)(5).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

election under Code §936 is in effect for the taxable year; regulated investment companies and real estate investment trusts; and a DISC or former DISC.[88]

The Conference Report provides that, with respect to the golden parachute provisions the Agreement follows the Senate amendment. The Conference Report, however, in its only reference to the golden parachute technical correction provisions states that it is not intended, with respect to the golden parachute provisions relating to the adoption of the affiliated group rules, to create an inference with respect to the definition of a change in control.[89]

5. Limitation on Number of Individuals Treated As Highly Compensated

Under pre-TRA law, all employees, independent contractors, or other persons who were officers, shareholders, or highly compensated individuals were treated as disqualified individuals under the golden parachute rules. The Act limits the number of individuals that may be treated as highly compensated to 250 employees of the corporation.[90] Specifically, the Act provides that the term "highly compensated individual" only includes an individual who is (or would be if the individual were an employee) a member of the group consisting of the highest-paid 1% of the employees of the corporation or, if less, the highest-paid 250 employees of the corporation.[91] The Senate Report indicates that the term "highly compensated individual" is defined to include only an employee (or former employee) who is among the highest-paid 1% of individuals performing services for the corporation or for any corporation that is a member of an affiliated group, or the 250 highest-paid individuals who perform services for a corporation or for each member of an affiliated group.[92] It therefore appears that, for these purposes, the 250-employees rule does not apply on an affiliated group basis. Rather, it is the 250 highest-paid individuals who perform services for a *member* of an affiliated group.

6. Excluded Amounts Not Taken Into Account In Determining Whether Threshold Amount Is Met

The Act clarifies pre-TRA law by indicating that, if an amount is not treated as a parachute payment, it is also not taken into account in determining whether the threshold contained in the definition of a parachute payment is exceeded. The threshold is whether the compensation paid equals or exceeds three times the base amount. For this purpose, payments made with respect to a small business corporation or a corporation that satisfies the shareholder approval requirements; payments that are reasonable compensation for personal services to be rendered on or after the date of the change in ownership or control; and payments from or under a qualified plan are not taken into account.[93]

7. Limitation on Treatment of Payment Pursuant to Securities Law Violation as Parachute Payment

Pre-TRA law provides that a parachute payment includes any payment in the nature of compensation to a disqualified individual if the payment is pursuant to an agreement that violates any securities laws or regulations. The Act amends this provision to provide that there will only be a parachute payment if it is pursuant to an agreement that violates any *generally enforced* securities laws or regulations, thereby limiting the application of the golden parachute rules. Further, the Act provides that the burden of proof with respect to establishing that there is a violation of a law or regulation is on the Secretary of the Treasury.[94]

8. Clarification Concerning Independent Contractors

While the definition of disqualified individual under pre-1986 TRA law clearly includes an independent contractor, the definition of base period only refers to the period during which the disqualified individual was "an employee" of the corporation. The Act replaces "employee of the corporation" with "perform personal services" for the corporation.[95]

9. Clarification of Effective Date Provisions

The Senate Report provides that the golden parachute technical corrections are effective as if enacted as part of the Tax Reform Act of 1984. Thus, for example, amounts paid before the 1984 TRA date of enactment (June 15, 1984) under an agreement otherwise subject to the golden parachute provisions, may be exempt from the provisions under the small business corporation exception, the shareholder approval exception, the exception for payments from or under a qualified plan, or exceptions for payments of reasonable compensation for services to be rendered. In addition, shareholder approval may be obtained after the date of enactment of the 1984 TRA with respect to prior transactions.[96]

The Senate Report also clarifies that, where a nonqualified stock bonus plan is amended to prevent the forfeiture of previously granted but unvested shares in the event of the termination of the plan following a merger, consolidation or sale, the plan amendment will not be treated as a significant or relevant amendment which would deny the grandfathering provisions to the grant of shares under the plan prior to June 15, 1984.[97]

V. Group Term Insurance Technical Corrections

A. Introduction

Under pre-1986 TRA law, the cost of §79 group-term life insurance purchased by an employer for an employee is included in the gross income of that employee to the extent that its cost exceeds the amount necessary for purchase $50,000 of coverage plus any employee contributions towards the purchase of the insurance. This $50,000 limit applies to active employees and former employees other

[88] Senate Report, p. 920.
[89] Conference Report at II-844.
[90] Act §1805(j)(5) amending Code §280G(c).
[91] Act §1805(j)(5) amending Code §280G(c).
[92] Senate Report, p. 920.
[93] Act §1805(j)(6) amending Code §280G(b)(2)(A).
[94] Act §1805(j)(7) amending Code §280G(b)(2)(B).
[95] Act §1805(j)(8) amending Code §280G(d)(2).
[96] Senate Report, p. 921.
[97] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

than employees who terminated employment due to a disability. The cost of the insurance, generally, is computed under a table prescribed by regulations. If a group-term life insurance plan discriminates in favor of key employees, the full cost of the insurance is included in the gross income of the key employee at its actual cost, rather than its tabular cost. Subject to certain transition rules, the 1984 Tax Reform Act extended the application of the group-term life insurance rules to former employees.

B. Overview

The Act clarifies some of the existing group-term life insurance rules. First, it clarifies the definition of the cost includible in the gross income of a key employee participating in a discriminatory plan.[98]

Second, the Act clarifies the effective date of the 1984 TRA amendments relating to the treatment of former employees in the case of existing plans.[99]

Third, the Act amends the definition of key employee [100] and provides for the separate treatment of former employees in the application of the nondiscrimination rules.[101]

The Act also makes a conforming clerical amendment to §83.[102]

VI. Detailed Analysis

A. Determination of Includible Cost

The Act clarifies that, if a plan discriminates in favor of key employees, the cost of group-term life insurance includible in the gross income of a key employee shall equal the greater of:

(1) the actual cost of the insurance; or

(2) the §79(c) tabular cost.[103]

This provision applies to taxable years beginning after the date of enactment of the 1986 Act.[104]

B. Former Employees

The Act clarifies the effective dates of the 1984 TRA amendments which extended the $50,000 limit on excludible group-term life insurance to retired employees and the nondiscrimination rules to former employees.[105] These amendments do not apply to any plan in existence on January 1, 1984 (or a comparable successor to such plan) with respect to individuals who both attained age 55 on or before January 1, 1984 and were employed by the employer or its predecessor at any time during 1983.[106] Moreover, the 1984 TRA amendments also do not apply to employees who retired on or before January 1, 1984 and who were covered by the plan (or its predecessor) at the time of retirement.[107]

In applying the nondiscrimination rules, the employer may elect to disregard grandfathered employees.[108]

The Act also clarifies that, with respect to grandfathered individuals, a comparable successor plan includes any plan which does not provide increased benefits.[109] Thus, if the benefits provided to a grandfathered individual are increased that person will no longer come under the grandfather rule.[110]

C. Definition of Key Employee

The Act amends §79(d) by revising the definition of key employee to include any former employee who was a key employee at the time of retirement or separation from service.[111] The Senate Report states that an employee would be considered a key employee at the time of separation from service if the employee was a key employee for the year in which separation occurred or any of the four preceding years.[112]

D. Separate Treatment of Former Employees

The Act further amends §79(d) by providing that the coverage and benefit tests applicable in determining whether a plan discriminates will be applied separately to active and former employees.[113]

E. Coordination with Section 83

Pre-1986 TRA §83(e)(5) exempts "the cost of" group-term life insurance from the application of §83. The Act provides that §83 shall not apply to group term life insurance covered by §79 (*i.e.*, it strikes the reference to "the cost of" such insurance).[114] Therefore, the value of any group-term life insurance which becomes nonforfeitable upon retirement will be taxed to the employee in accordance with the principles of §79, rather than §83.[115]

F. Effective Date

The group-term life insurance technical amendments are effective as if included in the provisions of the Tax Reform Act of 1984 to which they relate,[116] except that amendment to §79(d)(1)(B) relating to the determination of the cost of §79 insurance to a key employee is effective for taxable years ending after the date of enactment of the 1986 Act.[117]

---

[98] Act §1827(a).
[99] Act §1827(b).
[100] Act §1827(c).
[101] Act §1827(d).
[102] Act §1827(e).
[103] Act §1827(a)(1).
[104] Act §1827(a)(2).
[105] Act §1827(b).
[106] Act §1827(b)(1); Senate Report, p. 996.
[107] *Id.*
[108] Act §1827(b)(2); Senate Report, p. 996.
[109] Act §1827(b)(3); Senate Report, p. 996.
[110] Senate Report, p. 996.
[111] Act §1827(c).
[112] Senate Report, p. 996.
[113] Act §1827(d).
[114] Act §1827(e).
[115] Senate Report, p.996.
[116] Act §1881.
[117] Act §1827(a)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 52

NEW PROVISIONS FOR ESOPS

Taina E. Edlund, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

An employee stock ownership plan ("ESOP") is a qualified plan under which employer stock is held for the benefit of employees. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust. Dividends paid on stock held in trust for employees may be distributed to employees or may be held in the trust.

There are two basic types of ESOPs: an employee stock ownership plan (commonly known as an ESOP) and a tax credit ESOP. ESOPs and tax credit ESOPs have several common statutory requirements. Each must be: (1) a defined contribution plan; that (2) meets the requirements of §401(a); (3) is designed to invest primarily in employer securities; and (4) meets the requirements of §409(e) [giving participants certain voting rights] and (h) [giving participants the right to demand employer securities and to require the employer to repurchase them].

Section 409(l) defines "employer securities" as common stock issued by the employer which is readily tradable on an established securities market. If such common stock does not exist, "employer securities" means common stock issued by the employer having a combination of voting power and dividend rights equal to, or in excess of, the class of the employer's common stock having the greatest voting power and the class of stock having the greatest dividend rights. §409(l)(2). In addition, "employer securities" include noncallable preferred stock if such stock is convertible at any time into the qualified common stock described above, at a conversion price which (as of the date of acquisition by the ESOP or tax credit ESOP) is reasonable. §409(l)(3). Employer securities issued by any member of a controlled group of corporations are treated as employer securities for all members of the controlled group. For purposes of §409, "employer securities" include securities issued by a member of a controlled group of corporations. Section 409(l)(4) provides that "controlled group of corporations" has the meaning given to such term by §1563(a) (determined without regard to §§1563(a)(4) and (e)(3)(C)) but the common parent need own only 50% (rather than 80%) of the voting stock and each class of nonvoting stock of a first tier subsidiary for that subsidiary and the others below it to qualify as members of the controlled group.

In general, if the employer has a class of securities required to be registered under Section 12 of the Securities and Exchange Act of 1934 or class of securities that would be required to be so registered except for the exemption from registration provided by §12(g)(2)(H) of the Exchange Act, the ESOP or tax credit ESOP must permit each participant to direct the voting of the securities allocated to his account.

An ESOP maintained by an employer that does not have registration-type class securities is not required to pass through voting rights to participants, except to the extent required by §409(e). Consequently, the vote pass-through is only required with respect to certain major issues which, under applicable state law or charter, must be decided by a "more than a majority vote of the outstanding common shares voted" (*e.g.*, mergers, consolidations, sales of substantially all of the corporation's assets). Further, under §401(a)(22), if any §401(a) defined contribution plan, including an ESOP but excluding a profit-sharing plan, is maintained by an employer the stock of which is not publicly-traded, and if, after acquiring securities of the employer more than 10% of the plan's assets are held in employer securities, voting rights must be passed through to participants in accordance with §409(e).[1]

Unless the employer securities are readily tradable on an established securities market, §409(h)(1)(B) requires that participants must be given the right to require the employer (not the ESOP) to repurchase the employer securities under a fair valuation formula.

Section 4975(e)(7) defines "employee stock ownership plan" as a defined contribution plan which (1) is a stock bonus plan qualified under §401(a) or a combination of a stock bonus and money purchase plan, both of which are qualified under §401(a); (2) is designed to invest primarily in qualifying employer securities; (3) is otherwise defined in regulations prescribed by the Secretary of the Treasury; and (4) meets the requirements of §§409(e) and (h).

Although a tax credit ESOP may be any type of defined contribution plan (except a money purchase pension plan alone), a leveraged ESOP may only be a stock bonus plan or a combination stock bonus and money purchase plan. *See* §§409(a) and 4975(e)(7).

---

[1] *See* §§409(e) and 401(a)(22).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Like all qualified defined contribution plans, an ESOP must provide a formula for allocating employer contributions and forfeitures to the participant's individual accounts.[2] The allocation formula may not discriminate in favor of officers, shareholders or highly paid employees.[3] Normally, allocations will be proportionate to the employee's compensation, but other factors, such as years of service, may be considered. However, in the case of a tax credit ESOP, the allocation of employer securities to participants' accounts must be based on the participants' relative compensation for the year. §409(b). Where the qualifying employer securities acquired by the plan are acquired with the proceeds of an exempt loan, such securities are to be placed in a suspense account.[4] As the principal and interest of the loan is repaid, a ratable amount of securities must be released from the suspense account and allocated to the accounts of participants for the year of repayment.[5] Regs. §54.4975-8(ii) also permits an alternative release and allocation method based on principal payments only. Income derived from securities acquired with the proceeds of an exempt loan must be allocated as income from the plan or, if the plan so provides, used to repay the exempt loan.[6] In the event of forfeitures, securities released from the suspense account must be forfeited only after other assets.[7]

A loan to an ESOP from a disqualified person, or which is guaranteed by a disqualified person, or collateralized by assets of a disqualified person, is prohibited except for the limited exemption granted leveraged ESOPs.[8] For this purpose, "disqualified person" has the meaning supplied by §4975. It is essentially the same as a "party-in-interest" under ERISA. The loan proceeds must be used within a reasonable time after their receipt to acquire qualifying employer securities or to repay the loan or a prior exempt loan.[9]

The Tax Reform Act of 1984 amended the ESOP provisions by adding several significant tax incentives designed to encourage employee stock ownership. First, the legislation permitted a tax-free rollover of the proceeds from the sale of a business to an ESOP or to certain worker-owned cooperatives, provided (1) immediately after the sale, the ESOP owns at least 30% of the value of employer securities; and (2) which the 15-month period beginning three months before the date of sale "qualified replacement securities" (as defined in §1042(c)(4)) are purchased by the seller. §1042(a) and (b). Second, the 1984 Act enacted a corporate deduction for dividends paid on ESOP stock, provided, *inter alia*, the dividends are paid out currently to employees. §404(k). Third, a bank, insurance company, or other commercial lender is permitted to exclude from income 50% of the interest received on loans to ESOP sponsors, provided the loan proceeds are used to finance an ESOP's acquisition of employer stock. §133(a). Fourth, part or all of an estate's liability for estate taxes may be assumed by an ESOP in return for a transfer from the decedent or decedent's estate of "employer securities" of an equal value, provided the company sponsoring the ESOP guarantees payment of the taxes. §2210(a). All of the changes made by the Tax Reform Act of 1984 greatly increased the utility of an ESOP as a method of corporate finance. For a complete discussion of the rules relating to ESOPs, *see* 354 T.M., *ESOPs*.

II. Overview

The Tax Reform Act of 1986 adds several tax incentives encouraging the utilization of an ESOP as both a means of corporate finance and an employee benefit plan. Thus, the Act (1) adds an estate tax exclusion for 50% of the proceeds of certain sales to ESOPs;[10] (2) expands the §404(k) employer deduction for dividends paid on ESOP stock;[11] (3) expands the partial interest exclusion by extending it to mutual funds and certain refinancings of loans, and (4) exempts reversions from defined benefit plans that are transferred to ESOPs within prescribed time limits from the new 10% reversion tax.

In addition to adding these tax incentives, the Act also makes several changes to the general ESOP provisions. First, the Act repeals the payroll based ESOP tax credit effective for compensation earned or accrued after December 31, 1986.[12] Second, the Act accelerates the otherwise applicable benefit commencement dates.[13] Third, distributions from ESOPs prior to January 1, 1990 will be exempt from the 10% tax on early distributions from qualified plans provided that certain requirements are met. Fourth, the Act also modifies the time period over which an employer may pay the put option price.[14] Fifth, effective for stock acquired after December 31, 1986, the Act requires that a plan offer qualified participants the opportunity to elect partial diversification of their accounts.[15] Sixth, the Act also adds a requirement that an independent appraiser make all valuations of nonreadily tradable employer securities with respect to activities carried on by the plan.[16] Seventh, the Act adds a new section imposing a 50% excise tax on certain allocations of qualified securities.[17]

Finally, the Act makes several other technical corrections to the §1042 nonrecognition rules[18] and the §2210 relief from estate tax liability rule.[19]

III. Detailed Analysis

A. Estate Tax Exclusion

The Act adds new Code §2057[20] which provides an exclusion from a decedent's gross estate of 50% of the

[2] Regs. §1.401-1(b)(1)(ii) and (iii).
[3] §401(a).
[4] Regs. §54.4975-11(d)(1).
[5] Regs. §54.4975-11(c) and (d).
[6] Regs. §54.4975-11(d)(3).
[7] Regs. §54.4975-11(d)(4).
[8] Regs. §54.4975-7(b)(1)(ii).
[9] Regs. §54.4975-7(b)(4).

[10] Act §1172.
[11] Act §1173(a).
[12] Act §1171(a).
[13] Act §1174(b).
[14] Act §1174(c).
[15] Act §1175(a).
[16] Act §1175(a)(1).
[17] Act §§1854(a)(9)(A) and 1172(b)(2)(A).
[18] Act §1854(a)(9).
[19] Act §1854(d)(2).
[20] Act §1172(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

qualified proceeds from a qualified sale of employer securities by the executor of an estate to an ESOP prior to the due date of the estate tax return (including extensions). This provision applies to sales after October 22, 1986 (the Act's enactment date) and before January 1, 1992. §2057(f); Act §1172(c).

Section 2057(b) provides that a qualified sale is any sale of employer securities within the meaning of §409(l) by an executor of an estate to either (1) an ESOP described in §4975(e)(7), or (2) a §1042(c)(2) eligible worker owned cooperative.

In general, qualified proceeds are amounts received by the estate from the sale of employer securities that have been issued by a domestic corporation if the sale occurs at any time prior to the due date, including extensions, of the estate tax return.[21] Qualified proceeds, however, do not include the proceeds from a sale if the decedent received the employer securities (1) from a qualified §401(a) plan, or (2) as a transfer pursuant to an option or other right to acquire stock to which §§83, 422, 422A, 423 or 424 applies.[22]

Observation: The restricted definition of employer securities means that the exclusion is unavailable pursuant to an ESOP distribution or an employment related transaction. To be eligible for the exclusion, the executor of the estate must file a verified written statement with the Secretary.[23] This statement must contain a written statement by either the employer whose employees are covered by the ESOP or the authorized officer of a worker-owned cooperative consenting to the application of the new §4979A penalties regarding prohibited allocations of qualified securities.

B. Deductibility of Dividends

Effective for taxable years beginning after the date of enactment (October 22, 1986), the Act expands the §404(k) employer deduction available for dividends paid on ESOP stock to include dividends used to make payments on an exempt loan.[24] The legislative history also clarifies that dividends which are used to repay an exempt loan would not constitute an annual addition under §415.[25] Moreover, dividends on unallocated shares held in a pledge suspense account are also deductible.[26] The Act further amends §404(k) to clarify that dividends will be deductible in the year in which they are paid or distributed to the participant.[27] Dividends used to repay exempt loans are deductible in the year of repayment.[28] However, if the Secretary determines that the dividend contributes to the avoidance of taxation, the deduction may be disallowed.[29]

Finally, whereas under pre-1986 TRA law, §404(k)(2) provided that dividend payments were to be made only to "plan participants," Act §1854(b)(5) amends §404(k)(2) to provide that such dividend payments are to be made to "plan participants or their beneficiaries."

Note: Such liberalization of the dividend deductibility rules should further stimulate the use of ESOPs as a means of corporate financing, thereby reflecting the Congressional intent to create a tax favored tool for corporate capitalization.

C. Partial Interest Exclusion

The Act extends the availability of the 50% exclusion for interest paid on securities acquisition loans.[30] First, §851 regulated investment companies, *i.e.*, mutual funds, are added to the group of lenders eligible for the interest exclusion.[31] The Conference Report states that a mutual fund which is fully invested in ESOP obligations may pay out exempt interest obligations despite having certain amounts of cash or other assets on hand at the end of a taxable quarter.[32] The Secretary is directed to promulgate appropriate regulations which reflect this intent.

Moreover, since only 50% of the interest income from ESOP loans is excludible,[33] the Conference Report suggests that it may be appropriate for the mutual fund to have two classes of stock, one paying exempt interest dividends and the other paying taxable dividends. Such two class arrangements would not be subject to §654 (relating to series funds) since there would be no segregated portfolios of assets.[34] Extension of the partial interest exclusion to RICs is effective for loans used to acquire employer securities after the date of enactment (October 22, 1986), including refinancings of loans which were used to acquire employer securities after May 23, 1984.[35]

Observation: The permitted bifurcation of RIC income may give RICs a competitive advantage over other qualified lenders if it permits the RIC to allocate taxable interest to a tax-exempt institution and nontaxable interest to taxable institutions.

Second, as noted above, the partial interest exclusion also applies to refinancings of loans used to acquire securities after May 23, 1984.[36] The interest exclusion will also be available for loans made after the date of enactment which have a commitment date of no more than seven years, to the extent that, within 30 days, employer securities are transferred to the plan in an amount equal to the proceeds of the loan and the securities are allocable to participants' accounts within one year of the date of the loan.[37] The Conference Report clarifies that the seven year commitment period limit includes both the original commitment

[21] §2057(c)(1).
[22] §2057(c)(2).
[23] §2057(d).
[24] Act §1173(a).
[25] H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-558 (1986) ("Conf. Rept."); S. Rep. No. 313, 99th Cong., 2d Sess. p. 682 (1986).
[26] Conf. Rep. at p. II-852.
[27] Act §1854(b)(2).
[28] Act §1173(a)(2).
[29] Act§1854(b)(4). Effective as if enacted by the Tax Reform Act of 1984.
[30] Act §1173(b).
[31] Act §1173(b)(1), adding new subsection 133(a)(4).
[32] Conf. Rep. at II-559.
[33] Act §1173(b)(1)(B), amending §852(b)(5).
[34] Conf. Rep. at II-559.
[35] Act §1173(c)(2)(A).
[36] Act §1173(b)(2).
[37] Act §1173(b)(2)(B). The Conference Report, at II-559, clarifies that the 30-day period described in amended §133(b)(1)(B) for transferring employer securities to the plan begins on the date when interest begins to accrue on the loan. Similarly, the Report clarifies that the 1-year period described in amended §133(b)(1)(B) for allocating stock to a participant's account begins on the date interest begins to accrue on the loan.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

period and the period of any subsequent refinancing.[38] For example, if prior to the date of enactment, an otherwise qualified securities acquisition loan with an original commitment date of five years is refinanced for an additional four years, the partial interest exclusion applies only to interest accruing in the first seven years. Interest prepayments, however, will not qualify for the exclusion since it applies only to accrued interest. *See* Conf. Rep. at II-559.

D. Asset Reversions

If certain requirements, discussed *infra*, are met, the new 10% excise tax under §4980(a) on reversions to the employer from a defined benefit plan is waived regarding any portion of the reversion that is transferred from the qualified plan to a §4975(e)(7) ESOP.[39] If the reversion amount is transferred to the ESOP, it also will not be includible in the gross income of the employer. §4980(c)(3)(A).

Assets transferred to the ESOP must be invested in employer securities or used to repay a securities acquisition loan within 90 days (subject to extension by the Secretary of the Treasury) of the transfer. §4980(c)(3)(B). Neither the statute nor the Conference Report specify whether the loan must be a prior "exempt loan." In addition, under §409(d), the employer securities in which the investment is made must remain in the plan for 84 months after they are allocated to participants' accounts unless distribution to participants is permitted under circumstances described in §409(d)(1)-(3) in accordance with the terms of the plan.

At least half the participants in the transferor qualified plan must be participants in the ESOP as of the close of the first plan year for which an allocation of securities is required. The Conference Report provides that for purposes of determining who are participants in a plan, only active employees, not retirees, who are plan participants need be considered.[40] Moreover, in spinoff terminations, the employees who participated in the spun-off portion of the transferor plan prior to the spinoff will also be taken into account in meeting the number participants requirement.[41]

Amounts that are transferred and are not allocated to participant accounts in the year of the transfer due to the §415 limits, must be credited to a suspense account and allocated from that account to the accounts of participants no less rapidly than ratably over a period not to exceed seven years. When such allocations are made to a participant's account, the allocation is treated as an employer contribution for purposes of §415(c), except that the §415(c) annual addition will not exceed the value of such securities as of time they were credited to the suspense account, and no additional employer contribution will be permitted to an ESOP before the allocation of such amount. §4980(c)(3)(C)(ii). The Conference Report clarifies that the prohibition against employee contributions to an ESOP which receives a transfer from a terminated defined benefit plan is not intended to prohibit contributions to an ESOP to the extent that the amount of the suspense account required to be allocated for a year does not exceed the §415 limits.[42] Section 4980 is generally effective for reversions occurring after December 31, 1985.

Observation: Thus, Conference Report suggests that large allocations from a profit-sharing plan sponsored by the employer may be used to block the release of suspended securities in a given year.

E. Tax Credit ESOPs

The Act repeals the §41 payroll based ESOP tax credit effective for compensation earned or accrued after December 31, 1986.[43] The Act also modifies the rules regarding distributions from a tax credit ESOP.[44] Distributions prior to expiration of the 84 month period after which a security is allocated to a participant's account or the death, disability or separation from service of the participant will be permitted upon plan termination. Act §1174(a). The Conference Report indicates that a termination will include a partial termination of the plan with respect to employees of a particular subsidiary or operating trade or business of the employer in those cases where the employees retain no significant interest in the ESOP sponsor.[45] The distribution modification applies to plan terminations occurring after December 31, 1984.[46]

The Act also provides that the new minimum coverage requirements will not apply to tax credit ESOPs if the ESOP is the only qualified plan of the employer and (1) the plan benefits at least 50% of all employees eligible under a nondiscriminatory classification, and (2) the sum of all amounts allocated to a participant's account for the year does not exceed 2% of the participant's compensation for that year.[47] This provision is generally effective for plan years after December 31, 1988.

Query: Do amounts allocated include earnings, forfeitures, employee contributions, etc.?

F. Distributions

The Act accelerates the benefit commencement dates otherwise applicable to qualified plans.[48] Unless a participant otherwise elects, distribution of the participant's account balance will begin not later than one year after the close of the plan year:

(1) in which the participant terminates employment due to retirement, disability or death, or

(2) which is the fifth plan year following the plan year in which the employee separates from service for any other reason (as long as the employee is not reemployed during that same five-year period).[49]

These distribution rules do not apply to any portion of a participant's account balance which includes employer se-

[38] Conf. Rep. at II-559.
[39] Act §1132(a); new §4980(c)(3).
[40] Conf. Rep. at II-483.
[41] Cong. Rec. (9/27/86).
[42] Conf. Rep. at II-483.
[43] Act §1171(a).
[44] Act §1174(a).
[45] Conf. Rep. at II-558.
[46] Act §1174(a)(2).
[47] Act §1112(a) amending §410(b).
[48] Act §1174(b) adding §409(o).
[49] Act §1174(b)(1) adding §409(o)(1)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

curities acquired with the proceeds of an exempt loan until the close of the plan year in which the loan is fully repaid.[50]

Unless the plan otherwise provides, these distributions generally must be made over a five-year period in substantially equal periodic payments (but not less frequently than annually). However, if the participant's account balance exceeds $500,000, the payment period may be extended by one additional year per $100,000 (or fraction thereof) in excess of $500,000.[51] The payment period, however, cannot be extended by more than a total of five additional years, regardless of the amount of the participant's account balance.[52] These dollar amounts are indexed in the same manner as the benefit limits under a defined benefit plan.[53]

These amendments apply to distributions attributable to stock acquired after December 31, 1986. Act §1174(b)(3).

Certain distributions from ESOPS before January 1, 1990 are exempt from the 10% tax on early distributions from qualified plans to the extent that, on average, a majority of the plan's assets have been invested in employer securities for the 5-year period before the distribution.[54] This provision will not apply to any distribution which is attributable to assets which have not been invested in employer securities at all times during the 5-year period. §72(t)(2)(C)(ii). If an ESOP has existed for less than 5 years, the plan's assets must have been invested for the entire period before distribution. If the plan converted into an ESOP, assets must have been so invested for the five years prior to the distribution.[55] Tacking of investment periods is permitted.[56] To qualify for exemption, however, the distribution must be attributable to those assets which were invested in employer securities for five years.[57] The conferees also intend that, in determining the length of time a plan has held securities distributed to a participant, a first-in, first-out rule applies.[58]

These provisions are generally effective with respect to distributions made in taxable years after December 31, 1986. Act §1123(e).

G. Put Options

The Act modifies the period over which an employer may pay the put option price.[59] Upon exercise of a put option, the option price must be paid in substantially equal annual payments beginning not more than 30 days after the exercise of the option, over a period not to exceed five years. §409(h)(5)(A). If the employer defers payment over the 5-year period, or any portion thereof, adequate security and reasonable interest must be provided regarding any unpaid amounts. §409(h)(5)(B). The delayed payment provisions are applicable only to total distributions within one taxable year of the recipient of the account balance.[60]

In the case of an installment distribution (presumably any distribution less than a total distribution), the option price must be paid within 30 days of the exercise of the option.[61]

The Act also extends the put option requirement to all stock bonus plans.[62] Moreover, in applying the put option provisions to other stock bonus plans, "employer securities" will include any security of the employer held by the plan.[63]

The put option provisions are applicable to distributions attributable to stock acquired after December 31, 1986.[64] However, in the case of the revised payment requirements, the plan may elect to have the amendment apply to all distributions after the date of enactment.[65]

H. Diversification Requirements

Effective for stock acquired after December 31, 1986, the Act requires that a plan offer qualified participants the opportunity to elect partial diversification of their account balances.[66] A qualified participant is an employee who has attained age 55 and has completed at least 10 years of participation under the plan.[67] Diversification elections are made during an employee's qualified election period. The qualified election period means the 5-year period which begins with either (1) the plan year in which the participant attains age 55, or (2) if later, the plan year after the plan year in which the employee first became a qualified participant.[68] Diversification elections then will be made during the 90-day period beginning after the close of each plan year within the qualified election period.[69]

Observation: The House Report, clarifies that, if an employee has not completed at least at least 10 years of participation by the time he attains age 55, the qualified election period will begin in the first year after which 10 years of participation are completed and end with the plan year following the plan year in which age 60 is attained.[70] Thus, an employee who completes 10 years of service after the plan year following the plan year in which age 60 is reached will have no election period.

If the diversification election is made, the employee may direct the investment of up to 25% of the account balance, or up to 50% of such account balance in the last year of the 5-year election period (*i.e.*, generally after the employee attains age 60).[71] To the extent that self-direction is elected, the ESOP must offer a distribution of the portion of the participant's account balance covered by the election, or it must offer at least three investment options. These investment options must be consistent with regulations to

[50] Act §1174(b)(1) adding §409(o)(1)(B).
[51] Act §1174(b)(1), adding §409(o)(1)(C).
[52] Act §1174(b)(1), adding §409(o)(1)(C); Conf. Rep. at II-555, 558.
[53] §409(o)(2).
[54] Act §1123(a), adding §72(t)(2)(C); Conf. Rep. at II-457.
[55] Conf. Rep. at II-457-458.
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] Act §1174(c), adding §§409(h)(5) and (6).
[60] Conf. Rep. at II-555; §409(h)(5) (flush language).
[61] Act §1174(c) adding §409(h)(6).
[62] Act §1174(c)(2)(A), amending §401(a)(23).
[63] *Id.*
[64] Act §§1174(c)(1)(B) and (2)(B).
[65] Act §1174(c)(1)(B).
[66] Act §1175(a), adding §401(a)(28).
[67] Conf. Rep. at II-557.
[68] Act §1175(a)(1), adding §401(a)(28)(B)(iv).
[69] Act §1175(a)(1), adding §401(a)(28)(B)(i).
[70] House Rep. at 791.
[71] Conf. Rep. at II-557.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

be promulgated by the Treasury. §401(a)(28)(B)(ii). Although the statute is silent, the Conference Report provides that the diversification requirement cannot be satisfied through a distribution of employer securities.[72] The diversification requirement, however, will be satisfied if the qualified participant is offered the opportunity to transfer a portion of the employee's account balance into another plan allowing employee directed investment and containing the requisite diversification options.[73] The diversification requirement may also be satisfied by a distribution of that portion of the employee's account balance to which the election applies or cash in lieu thereof. If, under this rule, stock is distributed, the put option provisions will apply.[74] Moreover, amounts which are distributed to satisfy the diversification requirements may be rolled over to an IRA or another qualified plan.[75]

I. Independent Appraisal

The Act also provides that an independent appraiser, within the meaning of §170(a)(1), must make all valuations of employer securities not readily tradable on an established securities market with respect to activities carried on by the plan.[76] This amendment is effective for stock acquired after December 31, 1986. Act §1175(a)(2). The Conference Report does not clarify what is meant by the phrase "with respect to activities carried on by the plan." The House Report, however, indicates that the independent appraiser requirement applies to the valuation of employer securities contributed to or purchased by the ESOP.[77]

J. Prohibited Allocations

The Act provides that if there is a prohibited allocation of qualified securities by an ESOP or worker-owned cooperative, a 50% excise tax on the amount involved in the allocation is imposed on the employer or cooperative.[78] In addition, if a prohibited allocation occurs, the plan will be disqualified with respect to those participants receiving the prohibited allocation.[79] These participants, therefore, will include the amount of the allocation in income.[80] A prohibited allocation results if any portion of the assets attributable to (or allocable in lieu thereof) employer securities in a §1042 or §2057 qualified sale accrues to the benefit of:

(1) the taxpayer making the §1042 nonrecognition election;

(2) any person related to the taxpayer (within the meaning of §267(b)) or

(3) any other person who, after application of the §318(a) attribution rules, owns more than 25% of the value or the actual outstanding stock of the corporation (or certain related corporations) which issued the securities.[81]

To avoid the excise tax, an ESOP in which the decedent had an interest should not allocate to the decedent's account any assets involved in the qualified sale to the ESOP. Moreover, the employer should take care not to allocate other assets to the decedent in order to compensate for not making an allocation of the securities involved in the sale.[82]

A person is a 25% shareholder if such a person is a 25% shareholder at any time during the one year period ending on the date of the qualified sale. A person continues to be considered a 25% shareholder until all securities acquired in the sale are allocated.[83] A person will also be considered to be a 25% shareholder if such person is a 25% shareholder on the date the securities sold in the qualified sale are allocated. However, in that case, the individual is only a 25% shareholder regarding those securities allocated on the date the individual actually is a 25% shareholder.[84]

To determine whether the 25% ownership threshold is met, all securities allocated to a participant's account are treated as being owned by that participant.[85] However, persons ineligible to receive an allocation *solely* because they are lineal descendants of the taxpayer may receive an allocation of employer securities acquired in a qualified sale provided the total amount of securities so allocated to all lineal descendants does not exceed 5% of all employer securities acquired in the qualified sale.[86]

ESOPs which acquire securities in a qualified sale must provide that the prohibitions on allocations to the sellers, family members and 25% shareholders will be satisfied.[87] However, if the violation occurs during the nonallocation period, *i.e.*, more than 10 years after the securities were originally allocated, such restrictions shall not apply.[88]

K. Special Rules

Effective December 31, 1986, the Act amends §401(a)(22) to provide that the §409(e), pass through voting requirement will not apply to any employees in the business of publishing newspapers, and who are participants in any defined contribution plan established and maintained by their employer whose stock is not publicly traded.[89] In addition, nonvoting common stock of such an employer will be treated as employer securities if (1) the employer has a class of nonvoting common stock outstanding; and (2) the shares which the ESOP acquires have been issued and outstanding for at least 24 months.[90] This provision applies to stock acquisitions after December 31, 1986.[91] The Act also provides certain limited transition rules.[92]

L. Miscellaneous Technical Corrections

In addition to the changes discussed above, the Act also makes several technical corrections to provisions which

[72] Conf. Rep. at II-557.
[73] Conf. Rep. at II-558.
[74] Conf. Rep. at II-557.
[75] Conf. Rep. at II-558.
[76] Act §1175(a)(1), adding §401(a)(28)(C).
[77] House Rep. at 794.
[78] Act §§1854(a)(9)(A); 1172(b)(2)(A) and (B).
[79] Sen. Rep. at 682.
[80] *Id.*
[81] Act §§1854(a)(3)(A) and 1172(b)(1)(A)-(C).
[82] Sen. Rep. at 681.
[83] *Id.*
[84] Sen. Rep. at 681-82.
[85] Sen. Rep. at 682.
[86] Conf. Rep. at II-852; Sen. Rep. at 682.
[87] Sen. Rep. at 682.
[88] *Id.*
[89] Act §1176(a), amending §401(a)(22).
[90] Act §1176(b), amending §409(e).
[91] Act §1176(c).
[92] Act §1177(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

have an impact on ESOPs. First, the Act makes several amendments to §1042, regarding the nonrecognition of gain on sales of stock to ESOPs or §1042(c) worker cooperatives. Second, the Act also amends §2210 regarding the liability for payment of the estate tax in cases where employer securities are transferred to an ESOP or an eligible worker-owned cooperative.

1. Section 1042 Nonrecognition Rules

Act §1854(a) amends the §1042(b) requirement that the ESOP or cooperative must own at least 30% of the employer securities after the sale. Applicable to sales after July 18, 1984 and before the date of enactment, the ESOPs or cooperative must own at least 30% of either the actual securities outstanding or their value. §1042(b)(2). Applicable to sales after the Act's enactment date, the ESOP or cooperative must own, immediately after the sale, at least 30% of either the total number of shares of all classes of stock (other than §1504(a)(4) preferred stock) or the value of all outstanding stock of the corporation which issued the qualified employer securities.[93] The Act also provides that stock ownership for §1042(b) purposes shall be determined under the attribution rules of §318(a)(4). This provision applies to sales after May 6, 1986. Act §1854(a)(1)(B)(i).

The Act also amends the §1042(c)(4) definition of qualified replacement property.[94] The Act clarifies that qualified replacement property is limited to securities which are issued by a domestic operating company other than the corporation (or a member of the same controlled group) that issued the securities involved in the nonrecognition transaction.[95] A domestic operating corporation, generally, is a corporation more than 50% of the assets of which were, at the time the securities were purchased, used in the active conduct of a trade or business.[96] Section 581 or 583 financial institutions and insurance companies are included in the definition of an operating corporation.[97] If the corporation issuing the qualified replacement property either controls or is controlled (within the meaning of §304(c)) by one or more other corporations, all the corporations will be treated as one corporation for purposes of determining whether the corporation is a domestic operating corporation or the corporation which issued the qualified securities.[98]

The Act also clarifies that securities issued by a government or political subdivision will not be considered qualified replacement property.[99]

The Act further provides that §1042(a) nonrecognition treatment does not apply to any gain on the sale of qualified securities which is includible in the gross income of any subchapter C corporation.[100] This amendment is generally effective for sales after March 28, 1985, except it will not apply to sales made before July 1, 1986, if made pursuant to a binding contract in effect on March 28, 1985, and at all times thereafter. Act §1854(a)(6)(B)and (C).

Effective for dispositions after the date of enactment, in taxable years ending after that date, the Act also clarifies the coordination between the §1042 requirement that gain be recognized upon the disposition of any qualified replacement property and other provisions providing nonrecognition treatment.[101] New §1042(e) overrides other nonrecognition provisions and requires that gain realized upon disposition of qualified replacement property be realized at the time of the disposition. Gain, however, will not be recognized upon: (1) dispositions at death; (2) dispositions by gift; (3) certain exchanges in the event of a reorganization; or (4) subsequent sales by an ESOP in a §1042(a) transaction.[102] The amount of gain that may be recognized is limited to the amount that was previously unrecognized due to the acquisition of qualified replacement property.[103] A special rule applies in the case of a corporation controlled (within the meaning of §304(c)) by the taxpayer seeking nonrecognition treatment. If the taxpayer controls the corporation issuing the qualified replacement property, the taxpayer is treated as having disposed of the qualified replacement property when the corporation disposes of a substantial part of its assets other than in the ordinary course of its business.[104]

Section 1042(e) applies to dispositions after the date of the enactment of the Act (October 22, 1986), in taxable years ending after such date.[105]

2. Section 2210 Estate Tax Liability Changes

The Act amends §2210 to clarify that, with respect to decedents dying after September 27, 1985, only executors of estates which are eligible to make deferred payments of estate taxes under §6166 may be relieved of estate tax liability under §2210.[106] The Act further clarifies that the transfer of employer securities to an ESOP or eligible cooperative will not be deemed a disposition or withdrawal triggering the acceleration of tax payments under §6166(g).[107] Moreover, after the transfer, the ongoing ability of the ESOP or cooperative and the estate to make installment payments applicable to their respective interests shall be tested separately.[108] Thus, cumulative dispositions and withdrawals of amounts up to 50% of the estate's remaining interest would be permitted without triggering the acceleration of any unpaid tax.[109] Cumulative dispositions or withdrawals of up to 50% of the interest transferred to the ESOP or cooperative would also be allowed without triggering acceleration.[110]

The Act also provides that ESOP distributions to participants on account of death, disability, retirement or separations from service which result in a one year break in service, will not trigger the acceleration of any unpaid tax.[111] Moreover, no executor will be relieved of estate tax liability due to a transfer to an eligible cooperative unless that cooperative guarantees the payment of the tax liability.[112]

[93] Act §1854(a)(2)(A); Sen. Rep. at 1030.
[94] Act §1854(a)(5)(A).
[95] Sen. Rep. at 1029.
[96] §1024(c)(4)(B); Sen. Rep. at 1029.
[97] §1042(c)(4)(B)(ii).
[98] §1042(c)(4)(C); Sen. Rep. at 1029.
[99] Act §1854(a)(5)(A); Sen. Rep. at 1029.
[100] Act §1854(a)(6)(A), adding new §1042(c)(7).
[101] Act §1854(a)(8)(A).
[102] §1042(e)(3); Sen. Rep. at 1032-33.
[103] §1042(e)(1); Sen. Rep. at 1033.
[104] §1042(e)(2); Sen. Rep. at 1033.
[105] Act §1854(a)(8)(B).
[106] Act §1854(d)(1)(A) and (B).
[107] Act §1854(d)(2), adding new §2210(c)(3).
[108] §2210(c)(3)(B); Sen. Rep. at 1037.
[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] Act §1854(d)(5); Sen. Rep. at 1037.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 53

WELFARE PLANS

Taina E. Edlund, Esq.
Diane J. Fuchs, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. Pre-1986 TRA Law

Under pre-1986 TRA law, statutory employee benefit plans were subject to disparate nondiscrimination rules. Indeed, some plans were not subject to any nondiscrimination rules. Generally, if a plan favored highly compensated employees, the income tax exclusion for either all employees receiving the benefit or only the employee in whose favor discrimination is prohibited was denied. No uniform definition of highly compensated employee, however, applied to statutory employee benefit plans. Due to these differing standards, an employer could maintain two different types of plans for the same group of employees, and have one considered discriminatory, while the other might satisfy the applicable Code standards.

1. Health Plans

Under pre-1986 TRA law, no nondiscrimination tests applied to health benefits provided under a §105 insured employer-sponsored medical reimbursement plan. If, however, benefits were provided under a §105(h) self-insured medical reimbursement plan, a highly compensated employee could exclude a medical reimbursement only to the extent that the plan did not discriminate in favor of highly compensated employees, *i.e.,* amounts in excess of the benefits provided rank-and-file employees, known as "excess reimbursements," were taxable to the highly compensated.

Self-insured plans were considered discriminatory if they favored highly compensated employees regarding eligibility or benefits. Under the eligibility test of §105(h)(3), the plan was required to benefit (1) at least 70% of all employees, (2) at least 80% of all eligible employees, but only if 70% of all employees were eligible to participate, or (3) a class of employees that did not discriminate in favor of the highly compensated. In determining whether these criteria were met, an employer could exclude (1) employees who had not completed three years of service, (2) employees who had not reached age 25, (3) part-time or seasonal employees, (4) employees covered by a collective bargaining agreement, and (5) nonresident aliens earning no income from sources within the United States. In addition, all benefits provided for participants who are highly compensated employees were also required to be provided for the nonhighly compensated. Highly compensated employees were defined as (1) the five top salaried officers, (2) shareholders owning (after the application of §318) more than 10% in value of the employer's stock, and (3) employees in the top 25% of employees by salary (excluding nonparticipants and employees who are excludable for purposes of the eligibility test).

2. Group-Term Life Insurance Plans

Section 79 permits the exclusion of up to $50,000 of the cost of group term life insurance. Under pre-1986 TRA law, if a group term plan discriminated, key employees could not exclude the first $50,000 of the insurance cost. To be considered nondiscriminatory, the plan was required to satisfy one of the following eligibility tests:

(1) the plan had to benefit at least 70% of all employees;

(2) at least 85% of all participants had to be non-key employees;

(3) the class of employees receiving benefits must not have discriminated in favor of key employees; and

(4) if the plan was part of a cafeteria plan, the cafeteria plan requirements had to be met.

For purposes of these rules, an employer could exclude (1) employees who had not completed three years of service, (2) part-time and seasonal employees, (3) employees covered by a collective bargaining agreement, and (4) nonresident aliens having no income from sources within the United States.

All benefits available to key employees were required be available to all other employees. Group term benefits were not considered discriminatory, however, simply because the amount of life insurance provided bore a uniform relationship to compensation. A key employee was generally defined in the same manner as under the qualified plan top-heavy rules. Thus, key employees were officers, the top 10 owner-employees, 5% owners and 1% owners receiving at least $150,000 in annual compensation. If, at any time during the current year or any of the four preceding years, an employee fell into one of these categories, he or she would be a key employee in the current year.

3. Group Legal Services Plans

Section 120 permits an exclusion for contributions to, or services provided under, an employer-maintained group legal services plan. For the exclusion to be available, the plan must benefit a class of individuals that does not discriminate in favor of employees who are officers, shareholders, self-employed individuals or highly compensated. Moreover, the contributions or benefits provided under the plan may not discriminate in favor of these employees. For

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

purposes of testing for discrimination, employees covered under a collective bargaining agreement may be disregarded. In addition, the exclusion was not available if more than 25% of the amounts contributed during a year are provided for 5% owners or their spouses or dependents.

4. Educational Assistance Programs

Amounts paid or expenses incurred (up to $5,000 annually) under an employer-provided educational assistance program are excludable from income under §127. The exclusion, however, is not available if the plan discriminates in favor of employees who are officers, owners or highly compensated (or their dependents). Employees covered by a collective bargaining agreement may be excluded in determining whether the program discriminates. Moreover, no more than 5% of the amounts paid or incurred by the employer may be provided for 5% owners (or their spouses or dependents).

5. Dependent Care Assistance Programs

Section 129 provides an exclusion from income for amounts paid or incurred for an employee under a dependent care assistance program. For the exclusion to be available, the program must benefit a class of employees which does not discriminate in favor of employees who are officers, owners or highly compensated (or their dependents). Moreover, contributions or benefits provided under the plan may not discriminate in favor of these employees. Further, under the applicable concentration test, no more than 25% of the amounts paid or incurred may be provided for 5% owners (or their spouses or dependents). Employees covered under a collective bargaining agreement may be excluded in making the discrimination determination.

6. Welfare Benefit Funds

A voluntary employees' beneficiary association (VEBA) or a group legal services which is part of an employer plan is not tax-exempt unless the plan satisfies the §505(b) nondiscrimination rules. Thus, benefits may not be provided to a classification of employees which discriminates in favor of highly compensated employees. Moreover, no class of benefits may discriminate in favor of highly compensated employees.

7. Cafeteria Plans

Cafeteria plans are plans that offer participants a choice between cash and one or more employee benefits. The availability of these benefits choices on a nondiscriminatory basis does not give rise to the constructive receipt of income. If the plan discriminates in favor of the highly compensated, however, benefits are included in income.

B. Reasons for Change

According to the Conference Report, the provision of tax-favored employee benefits fulfills "important social policy objectives, such as increasing health insurance coverage among taxpayers who otherwise would not purchase or could not afford such coverage.[1] In enacting more stringent nondiscrimination rules, Congress indicated that these objectives would be furthered only if such benefits were available to a broader cross-section of employees. Moreover, under pre-TRA law, the definition of the prohibited group for discrimination purposes was vague, causing confusion.[2] Similarly, little guidance was provided under pre-TRA law regarding whether a pattern of coverage discriminated in favor of prohibited group members.

II. Overview

Code §89, as enacted by Act §1151(a), sets forth mandatory nondiscrimination rules for health and group term life insurance plans. Section 89 also, at the employer's election, may apply to other statutory employee benefit plans. These rules prohibit discrimination in favor of highly compensated employees (a term which Code §89 defines in a uniform manner). Health plans and group term life insurance plans may satisfy the nondiscrimination rules in one of two ways: by meeting an 80% coverage test or by satisfying a three-prong eligibility test plus a benefits test. Statutory employee benefit plans to which the nondiscrimination rules are electively applied must satisfy the three-prong eligibility test plus the benefits test. The alternative 80% coverage test is not available to these plans. In determining whether a plan discriminates, certain employees may be excluded from consideration.

An employer may choose to apply the nondiscrimination rules on the basis of separate lines of business. Each option or different benefit offered under a plan, however, is treated as a separate plan and must be tested separately. Other special rules also apply in determining whether certain statutory employee benefit plans are discriminatory.

If a plan discriminates, highly compensated employees must include the value of the discriminatory excess in gross income. The value of this excess varies depending on the type of plan involved. In the case of health and group-term life insurance plans, the discriminatory excess is determined with regard to the value of coverage provided. The value of benefits provided is the measure for all other statutory employee benefit plans.

The Act also revised the plan formality, permanence and exclusivity requirements. First, the pre-TRA law writing, enforceability and permanence requirements were extended to qualified tuition reduction programs, group legal services plans, cafeteria plans, educational assistance programs, dependent care programs, §132 fringe benefit programs and benefits provided under a welfare benefit fund. Second, two additional requirements were added: (1) employees must be given reasonable notice of available benefits; and (2) the plan must be maintained for the exclusive benefit of the employees. If a plan fails to meet these requirements, the value of the benefits provided (rather than the value of coverage) is included in the gross income of employees, to the extent the benefits are attributable to employer contributions.

The Act also imposed reporting requirements on employers maintaining discriminatory plans or maintaining plans failing to meet the writing, permanence and exclusiv-

[1] H.R. Rep. 99-841, 99th Cong., 2d Sess., p. II-650 (1986) ("Conference Report").

[2] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ity requirements. In such cases, the amount to be included in gross income must be reported to the affected employee and the IRS on Form W-2. If the employer fails to report these amounts, a penalty is imposed. The amount of the penalty generally equals the total value of all employer-provided benefits of the same type provided to the employee multiplied by the highest individual tax rate. This penalty is imposed in addition to any other penalties imposed under either §6652 or §6678. The penalty tax is nondeductible and may not be offset by credits or deductions. The penalty is imposed even though the employee includes part or all of the nonexcludable benefits in income.

The Act also modified the Code provisions pertaining to cafeteria plans. The Act amended the definition of a cafeteria plan to include a plan under which a participant may elect only between qualified benefits. A revised benefits test is also imposed which requires that the qualified benefits provided to key employees cannot exceed 25% of the aggregate of such benefits for all employees. An employer, however, may limit the option elections of a highly compensated employee to ensure that the nondiscrimination rules are satisfied. The uniform definitions of highly compensated employee, excludable employee and employer also apply to cafeteria plans.

The general effective date of the nondiscrimination rules is for plan years beginning after the later of (1) December 31, 1987 or (2) the earlier of December 31, 1988, or the date which is three months after the issuance of regulations.

III. Detailed Analysis

A. Plan Formality, Permanence and Exclusivity Requirements

Under pre-1986 TRA law, accident or health plans and group term life insurance plans were required to meet the following requirements:

(1) The plan had to be in writing;

(2) The employees' rights under the plan had to be legally enforceable; and

(3) The plan had to be established with the intention of being maintained indefinitely.

The Act extended these requirements to qualified tuition reduction programs, group legal services plans, cafeteria plans, educational assistance programs, dependent care programs, miscellaneous §132 fringe benefit programs and benefits provided under a welfare benefit fund.[3]

In addition, the Act added two other requirements:

(1) Employees had to be provided reasonable notice of the nature of the benefits available under the plan; and

(2) The plan had to be maintained for the exclusive benefit of the employees or their spouses and/or dependents.[4]

The Act provides that multi-employer plans do not fail to meet the exclusive benefit requirement simply because employers' contributions are commingled and used to pay each other's benefits.[5]

The Conference Report offers some clarification of the requirement that a plan be legally enforceable. In essence, the employer may not retain the discretion to determine when, and to whom, benefits are payable. The legislative history states that a plan will not be considered legally enforceable if it is discretionary with the employer.[6] For instance, a health plan which permits an employer to reimburse medical expenses at its discretion would not be legally enforceable, since the employee could not compel payment.[7] A plan, however, will not fail to satisfy the legal enforceability requirement simply because an employer may terminate the plan respecting claims which have not been incurred by the time of termination. If the employer maintains the right to terminate the plan with respect to incurred claims, however, the employee's right to payment of claims will not be considered legally enforceable and, therefore, employees will be taxed on the value of their benefits.[8]

Observation: Although the Conference Report is ambiguous, the failure of a plan to restrict an employer's right to terminate a plan will render benefits taxable even if the right is never exercised.

Comment: The Conference Report offers no explanation of what is meant by "reasonable notification." A plan which complies with ERISA's summary plan description requirements would probably be deemed, under regulations, to satisfy the reasonable notification requirement. Law developed under ERISA may be of use in clarifying the post-TRA exclusive benefit requirement. Cases and rulings regarding the §401(a)(2) exclusive benefit requirement for qualified plans also may be relevant in interpreting this requirement.

If a plan fails to satisfy the formality, permanence, exclusivity, etc. requirements, the value of the benefits provided (rather than the value of the coverage) will be included in the employee's gross income in the taxable year in which the benefits are received, to the extent they are attributable to employer contributions.[9] For instance, if a health plan fails to meet these requirements, the services provided under the plan and any reimbursements received are included in income.[10] Both highly and nonhighly compensated employees must include such amounts in gross income.

Comment: Presumably, the employee also includes in gross income the value of benefits provided to the employee's spouse or dependents, with no income being recognized by the spouse or dependents.

---

[3] Act §1151(a) adding §89(k).
[4] *Id.*
[5] Act §1151(a) adding §89(k)(4).
[6] Conference Report, p. II-504.
[7] *Id.*
[8] *Id.* Of course, as the Conference Report notes, termination may violate the permanency requirement in some instances.
[9] Conference Report, p. II-504.
[10] *Id.*

B. Reporting Requirements

If a plan discriminates in favor of highly compensated employees, the employer must report the amount of the discriminatory excess to all affected employees and the IRS.[11] If the plan fails to meet the writing, permanency, exclusivity, etc. requirements, the amount includible in gross income also must be reported.[12] This amount is reported on Form W-2 by the due date, including extensions, for the filing of the form.[13]

If the employer (including a tax-exempt employer) fails to report the includible amount, §6652(l) imposes a penalty upon the employer.[14] The penalty is calculated by multiplying the total value of all employer-provided benefits of the same type provided to the employee by the highest individual income tax rate.[15] For purposes of determining the amount of employer-provided benefits, the value of the benefits provided, rather than the coverage, is to be used.[16] In the case of group term life insurance, the value of the benefit will equal the higher of the table cost or the actual cost of all coverage.[17]

The penalty tax of §652(l) is imposed in addition to any other penalties applicable under either §6652 or §6678.[18] The penalty, however, may be applied only once per employee per year.[19] The penalty tax is nondeductible and may not be offset by any credits or deductions.[20] Moreover, the penalty tax is due even though the employee actually includes part or all of the benefits in gross income.[21]

The penalty may be avoided if reasonable cause exists for the failure to comply with §89(l).[22] The Conference Report states that a reasonable difference in the valuation of health benefits prior to the issuance of valuation regulations constitutes reasonable cause.[23]

Comment: Presumably, precedent and regulations regarding what constitutes reasonable cause for not filing an annual report will be relevant in determining whether reasonable cause exists under §6652(l)(3).

C. Nondiscrimination Rules

1. Mandatory Versus Elective Application of Section 89

Section 89 mandatorily applies to §105(e) health or accident plans (hereinafter referred to as "health plans") and §79 group term life insurance plans.[24] Section 105(e) health plans include both insured and self-funded plans.[25] Section 89 does not apply, however, according to the Conference Report, to disability coverage to the extent that the proceeds payable under such coverage are included in the employee's gross income.[26] The Conference Report also provides that plans which provide ancillary benefits such as dental care, vision care or physical examinations are subject to §89.[27]

An employer may elect to treat any of the following plans as statutory employee benefit plans, thereby, making them subject to the §89 nondiscrimination tests:

(1) a §120(b) group legal services plan;

(2) a §127(b) educational assistance program; or

(3) a §129(d) dependent care assistance program.[28]

If an employer election is made, the plan need not satisfy any other additional nondiscrimination tests (aside from the §89 tests), provided the plan satisfies the applicable concentration of benefits.[29] Group legal service plans and educational assistance programs are not mandatory statutory employee benefit plans because the Code sections authorizing tax-favored treatment for such plans are scheduled to expire, unless renewed, prior to the effective date of §89.[30] If Congress extends the expiration date of these provisions, however, the Conference Report anticipates that they will be subject to the §89 rules.

2. Eligibility Tests

a. 50 Percent Test

Section 89(d)(1)(B) requires that at least 50% of the employees eligible to participate in a plan must be nonhighly compensated employees. This requirement will be satisfied if the alternative percentage test of §89(d)(2) is met. The §89(d)(2) alternative percentage test is met if the percentage of highly compensated employees who are eligible to participate does not exceed the percentage of nonhighly compensated employees eligible to participate. In illustrating this provision, the Conference Report considers an employer with 20 employees, 15 of whom are highly compensated.[31] Since more than 50% of its employees are highly compensated, the employer would fail the 50% test even if all of its employees were eligible to participate in the plan. If however, all employees are eligible, the employer would satisfy the alternative percentage test because the percentage of eligible highly compensated and nonhighly compensated employees would be the same, *i.e.*, 100%.

In applying either the 50% test or the alternative eligibility percentage test, comparable *health* plans may be aggregated.[32] Comparable plans, for purposes of the §89 rules, are plans of the same type in which the smallest benefit available to any participant is at least 95% of the

---

[11] Act §1151(a), adding §89(l).
[12] *Id.*
[13] Act §1151(a) adding §89(l); Conference Report, p. II-503.
[14] *See* Conference Report, p. II-503.
[15] Act §1151(b) amending §6652(l)(2).
[16] Act §1151(b) amending §6652(l)(2)(A); Conference Report, p. II-504.
[17] Conference Report, p. II-503.
[18] Act §1151(b) amending §6652(l)(4).
[19] Act §1151(b) adding §6652(l)(5).
[20] Conference Report, p. II-503.
[21] *Id.*
[22] Act §1151(b) adding §6652(l)(3).
[23] Conference Report, p. II-504.
[24] Act §1151(a) adding §89(i)(1).
[25] Regs. §1.105-5(a).
[26] Conference Report, p.II-508.
[27] *Id.*
[28] Act §1151(b) adding §89(i)(2).
[29] Act §11512(b) adding §89(j)(7). The applicable concentration tests are found in §120(c)(3), §127(b)(3) and §129(d)(4).
[30] Conference Report, p. II-508.
[31] Conference Report, p. II-509.
[32] Act §1151(a) adding §89(g)(1); Conference Report, p. II-509 and p. II-531-532.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

largest employer-provided benefit available to any participant in any such plan.[33]

b. 90/50 Percent Test

Section 89(d)(1)(A) requires that, for a plan to satisfy the §89(d) eligibility requirements, at least 90% of all nonhighly compensated employees (1) must be eligible to participate in the plan; and (2) if participating, must be eligible for an employer-provided benefit equal to at least 50% of the most valuable employer-provided benefit available to any highly compensated employee.[34]

For purposes of the 90/50% test, all plans of the same type (*i.e.*, all benefits excludable under the same Code section) are aggregated.[35] Therefore, if the employee is eligible to participate in two plans of the same type, the employee will be considered to be eligible for a benefit equal to the total value of benefits under both plans.[36] Similarly, in determining the highly compensated employee with the most valuable benefit, benefits under all plans of the same type are aggregated.[37]

In the case of health and group term life insurance plans, a participant's employer-provided benefit equals the value of that portion of the coverage provided which is attributable to employer contributions.[38] Tables assisting in the valuation of health plan coverage are to be issued.[39] For group term plans, the value of coverage is the §79(c) Table I cost, computed as though the employee were 40 years of age.[40] In applying the benefits test and the 50% component of the 90/50% test to a group term life insurance plan, the employer-provided benefit is the cost of insurance provided in the plan year under §79(c) for an individual who has attained age 40.[41] The benefit may be adjusted depending on an employee's compensation, unless a group term plan is aggregated with plans of a different type.[42] This adjustment is made by multiplying the amount by a fraction. The numerator is a uniform amount and the denominator is the employee's compensation.[43]

For purposes of this rule, the Conference Report states that a uniform definition of compensation enacted by the 1986 TRA for retirement plan and fringe benefit purposes applies.[44] Thus, compensation in excess of $200,000 is *not* taken into account in applying the benefits tests and the 50% component of the 90/50% test. Group-term life insurance coverage in excess of $50,000, however, cannot be disregarded, for this purpose, *i.e.*, it is treated as if provided through tax-favored dollars.[45]

Available salary reductions are not considered for purposes of the 90/50% test.[46] Moreover, to the extent that the availability of other benefits is contingent upon a salary reduction election, the contingent benefits can be allocated among different plans in any reasonable manner allowed by the Secretary and determined by the employer.[47]

With respect to health plans, in determining whether the 50% component of the 90/50% test (or the special 80% coverage test for health plans of §89(f)) is met, an employer may elect to separately test coverage of spouses and dependents by such plans and to consider only those employees with a spouse or dependent with respect to such coverage.[48] The Conference Report clarifies that coverage of an employee's spouse or dependent is tested together regardless of whether the employer maintains separate plans for employees with one spouse or dependent and for employees with two or more dependents.[49]

c. General Nondiscrimination

Section 89(d)(1)(C) provides that a plan may not contain any provision relating to eligibility that, by its terms or otherwise, favors highly-compensated employees. The Conference Report clarifies that §89(d)(1)(C) is not intended to disqualify arrangements where discrimination is quantifiable.[50] (This type of discrimination is covered by the various mathematical tests provided in §89.) Thus, the mere fact that an employer maintains separate plans for salaried and hourly employees and the benefits available under the hourly plan are less valuable than those available under the salaried plan would not cause the plan to be considered discriminatory. The §89(d)(1)(C) nondiscrimination test is designed to prevent more subtle forms of discrimination which are only apparent from an investigation of the facts and circumstances surrounding a plan. For instance, a plan may provide a benefit designed to satisfy the "highly individualized needs" of highly compensated employees, while ostensibly providing the same benefits to all employees. Thus, a plan providing unusual coverage for a rare disease to which only the owner or owner's dependent is subject, is discriminatory.[51]

3. Benefits Test

a. In General

Under §89, the average employer provided benefit actually received (*i.e.*, actual coverage) by nonhighly compensated employees under all plans of the same type must equal at least 75% of the employer-provided benefit received by highly compensated employees.[52] The "average employer-provided benefit" is an amount equal to the aggregate employer-provided benefit that is received by the employer's highly and nonhighly compensated employees, respectively, under all plans of the same type divided by the total number of highly or nonhighly compensated employ-

[33] Act §1151(a) adding §89(g)(1)(B).
[34] §89(d)(1)(A)(i)-(ii); Conference Report, p. II-509.
[35] Conference Report, p. II-509.
[36] Conference Report, p. II-509.
[37] Conference Report, p. II-509.
[38] Act §1151(a) adding §89(g)(3)(A)(i). In the case of any other benefit, it is the value of the employer-provided benefit. §89(g)(3)(A)(ii).
[39] Act §1151(a) adding §89(g)(3)(B). For a discussion of the valuation question, *see* III, M, 4, *infra*.
[40] Act §1151(a) adding §89(g)(3)(C)(i).
[41] Act §1151(a) adding §89(g)(3)(C)(i); Conference Report p. II-514.
[42] Conference Report, p. II-514.
[43] *Id.*
[44] *Id.*
[45] Conference Report, p. II-514.
[46] Act §1151(a) adding §89(g)(3)(D); Conference Report, p. II-509.
[47] Conference Report, P. II-510.
[48] Act §1151(a) adding §89(g)(6); Conference Report, p. II-510.
[49] Conference Report, p. II-510.
[50] Conference Report, p. II-510.
[51] Conference Report, p. II-510.
[52] Conference Report, P. II-510.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ees (whichever applies), regardless of whether they are covered by such plans.[53]

Plans of different types, other than health plans, may be aggregated for purposes of the benefits test, if the employer so elects under §89(g)(4).[54] Thus, the employer can aggregate the benefits provided under a group term life insurance plan and all group legal services plans (if the employer elects to treat the group legal services plans as statutory employee benefit plans).[55] Moreover, an employer may aggregate all accident and health plans with other types of plans in order to determine if the benefits test is met with respect to those other plans other than health plans.[56] If an employer chooses to aggregate, it must aggregate all plans of the same type. For example, if an employer wishing to aggregate maintains a group term life insurance plan and two group legal services plans, it must aggregate both group legal services plans with the group-term life insurance plan, not just one.[57]

If different types of plans are aggregated, the definition of excludable employee, *infra*, must be modified accordingly.[58] Thus, in determining which employees are excludable for purposes of determining the average employer-provided benefit, the definition is applied as if the aggregated plans constituted one plan.[59] The lowest age and service requirements of any of the aggregated plans, therefore, will apply.[60] Moreover, if members of a collective bargaining unit are not excluded for one plan, they cannot be excluded for the group of plans.[61] Therefore, in determining the average employer-provided benefit, the denominator of the fraction will be all nonexcludable employees as determined under the most expansive definition of any of the aggregated plans.[62]

b. Plan Safe Harbor

The Conference Report instructs the Secretary to prescribe regulations providing a safe harbor benefits test so that all benefits excludable under the same provision need not be valued.[63] Since the definition of a plan, *infra*, requires that all features be identical, any plan would, standing alone, satisfy the benefits test if based on the entire year, the percentage of nonhighly compensated employees benefited is not less than 75% of the highly compensated employees benefited.[64] Under this rule, an employer with multiple plans of the same type need aggregate plans only insofar as necessary to avoid discriminatory status. The employer thereby need only value the aggregated group. In an example provided in the Conference Report, for instance, where an employer maintains 10 health plans, one of which is discriminatory, the employer may aggregate the discriminatory plan with only so many of the other nine plans as is necessary to allow the group, as a whole, to satisfy the benefits test.[65]

c. Special Dependent Care Assistance Test

The Act applies a special benefits test to dependent care assistance plans which are not statutory employee benefit plans. In essence, the general benefits test, *supra*, applies with two modifications.[66] First, the average employer-provided benefit received by nonhighly compensated employees must be at least 55%, rather than 75%, of the average employer-provided benefit received by highly compensated employees.[67] Second, for purposes of applying the average benefits test to salary reduction amounts, employees with compensation, as defined by §414(q)(7), below $25, 000 per year will be disregarded.[68] If dependent care is provided both through salary reduction and otherwise, the treatment of employees earning less than $25,000 will be prescribed by regulations to be promulgated by the Secretary.

4. Alternative Test

A health plan or group term life insurance plan will not be considered discriminatory even if it fails the eligibility and benefits tests, discussed *supra*, so long as it complies with the alternative test set forth by §89(f). Under the alternative test, the plan will be considered nondiscriminatory if it benefits at least 80% of an employer's nonhighly compensated employees.[69] For purposes of this test, comparable plans may be aggregated, as described *supra*.[70] If, however, the plan (or plans) contain any provision which, by its terms or otherwise, discriminates in favor of highly compensated employees, the alternative test will not apply and the plan will have to satisfy the regular §89 eligibility and benefits tests.[71] Since the alternative test applies only to "insurance-type plans" (defined as accident or health plans and group-term life insurance plans, for purposes of the alternative test, eligibility for coverage is not sufficient; an individual must actually receive coverage to be considered as benefiting under the plan.[72]

Note: Employers having only one plan or a group of comparable plans are likely to satisfy this test, especially where such plans require no or minimum employee contributions.

5. Amount Includible in Income

If a plan discriminates in favor of highly compensated employees, §89(a) provides that an amount equal to the highly compensated employee's "excess benefit" will be included in the gross income of such employee in the employee's taxable year within which the plan year ends. In general, this discriminatory excess is the amount of the employer-provided benefit (including elective contribu-

[53] Act §1151(a) adding §89(e)(2); Conference Report, p. II-510.
[54] Conference Report, P. II-510.
[55] Conference Report, p. II-511.
[56] Conference Report, P. II-511.
[57] Conference Report, P. II-511.
[58] Conference Report, P. II-511.
[59] Conference Report, p. II-511.
[60] Conference Report, P. II-511.
[61] Conference Report, p. II-511.
[62] *Id.*
[63] Conference Report, p. II-514.
[64] *Id.*
[65] *Id.*
[66] Act §1151(f) amending §129(d); Conference Report, p. II-515.
[67] *Id.*
[68] *Id.*
[69] Code §89(f); Conference Report, p. II-511.
[70] Conference Report, p. II-511.
[71] *Id.*
[72] Conference Report, p. II-511.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tions) which would have to be paid in after-tax dollars to keep the plan nondiscriminatory.[73]

Specifically, a highly-compensated employee's excess benefit is defined as the excess of the employee's employer-provided benefit over the "highest permitted benefit." [74] To determine the highest permitted benefit, the nontaxable benefits of all highly compensated employees (beginning with employees with the greatest nontaxable benefits) under the plan are reduced by the amounts necessary to make the plan nondiscriminatory.[75] In reducing benefits, the Conference Report provides that, except as provided in regulations, benefits are reduced so as to satisfy the objective nondiscrimination tests in the following order:

(1) the 50% test;

(2) the 90/50% test; and

(3) the benefits test.

Alternatively, benefits may be reduced to satisfy the alternative 80% test.[76] The determination of the discriminatory excess with respect to the third eligibility test which generally prohibits discrimination in favor of highly compensated employees is to be made in accordance with regulations to be promulgated.[77]

In computing the excess benefit with respect to any type of benefit, all plans of the employer of the same type are taken into account.[78] In the case of health plans or group-term life insurance plans, the amount includible is the value of the coverage provided.[79] In the case of group-term life insurance, the value of coverage equals the greater of the cost of coverage under §79(c) (*i.e.*, the Table I rate) or the actual cost of coverage.[80] The Secretary is directed to issue tables assisting in the valuation of health plan coverage.[81] In the case of all other statutory employee benefit plans other than health plans and group-term life insurance, the discriminatory excess is determined with reference to the value of employer-provided benefits, not the value of coverage.[82]

D. Special Health Plan Rules

1. Separate Testing

If an employer maintains a health plan providing family coverage, the employer may elect to separately test the coverage for employees and the coverage for spouses or dependents.[83] All plans covering one or more family members of an employee are included in the definition of family coverage, regardless of whether a particular plan is limited to coverage of one family member, while another plan covers two or more members.[84] Separate testing can be applied only for purposes of the benefits test, the alternative 80% test and the 50% component of the 90/50% test.[85] The employer, however, may not aggregate with other non-health plans only family coverage or employee coverage.[86]

In separately testing coverage for spouses or dependents for purposes of the alternative 80% test and the 50% prong of the 90/50% test, an employer may consider only employees with spouses or dependents.[87]

Comment: Separate testing under the 80% test appears to have little value since 80% of nonhighly compensated employees, presumably, must still be covered. In applying the 90/50 test, however, separate testing may be more useful. For example, assume a plan provides uniform no cost coverage to all employees as well as for the family. If more than 10% of nonhighly compensated employees have no family, the plan fails the test since the value of coverage provided to at least 10% of nonhighly compensated employees is less than 50% of the value of coverage for employees with families. Where separate testing is used, however, the value of coverage provided to the families of the highly compensated may be disregarded.

For purposes of the benefits test, however, the employer may disregard only employees with spouses or dependents covered by another health plan providing core benefits which is maintained by another employer.[88] "Core benefits" are not specifically defined in the Act. Noncore benefits, however, according to the Conference Report and the Senate Report, consist of coverage for dental, vision, psychological and orthodontia expenses and elective cosmetic surgery.[89] If an employee or family member is excluded under this rule, any coverage actually provided to either the employee or to family members is disregarded in calculating the average employer-provided benefit fraction.[90] All of the employee's dependents must be covered by the other employer plan for this "core benefits" rule to apply.[91] Moreover, the core benefits rule does not apply if the employer's accident or health plan is aggregated with other plans in applying the benefits test to such other plans.[92] The employer may, however, in no event disregard highly compensated employees having coverage worth an amount that exceeds 133⅓% of the average employer-provided benefit for nonhighly compensated employees.[93] Moreover, if family coverage is tested separately, the family of a highly compensated employee may not be disregarded if such *family* coverage has a value exceeding 133⅓% of the average employer-provided benefits for the families of the nonhighly compensated.[94]

2. Sworn Statements

Any employer wishing to elect these optional separate testing rules must obtain (and preserve) sworn statements,

[73] §89(b); Conference Report, p. II-503.
[74] Act §1151(a) adding §89(b)(1).
[75] Act §1151(a) adding §89(b)(2); Conference Report, p. II-503.
[76] Conference Report, p. II-503.
[77] *Id.*
[78] Act §1151(a) adding §89(b)(3).
[79] Act §1115(a) adding §§89(a), (g)(3).
[80] Act §1151(a) adding §89(g)(3)(C)(ii); Conference Report, p. II-503.
[81] Act §1151(a) adding §89(g)(3)(B).
[82] Act §1151(a) adding §§89(a), (g)(3)(A)(ii).
[83] Act §1151(a) adding §§89(g)(2), (6); Conference Report, p. II-512
[84] Conference Report, p. II-512
[85] *Id.*
[86] Conference Report, p. II-512.
[87] Act §1151(a) adding §89(g)(6); Conference Report, p. II-513.
[88] Act §1151(a) adding §89(g)(2); Conference Report, p. II-512.
[89] Conference Report, p. II-512, 519; Senate Report, p. 658.
[90] *Id.*
[91] Conference Report, p. II-512
[92] *Id.*
[93] Act §1151(a) adding §89(g)(2)(D); Conference Report, p. II-512.
[94] Conference Report, p. II-513.

to be collected on IRS forms, regarding its employees' family and coverage status.[95] The statements need not be notarized.[96] The statements must include the name of the insurer and employer providing other coverage.[97] Absent a sworn statement, nonhighly compensated employees are presumed to have neither a family nor other core benefits coverage.[98] On the other hand, absent a sworn statement, highly compensated employees are presumed to have both a family and such other coverage.[99]

In lieu of obtaining these statements from all employees an employer may secure statements from a statistically valid sample in accordance with regulations to be promulgated.[100] This sampling must be performed by an independent third party.[101] If sampling is used, the rules regarding collection of statements and presumptions still apply.[102] The sampling, along with other information about it as may be required by the Secretary, must be attached to the employer's return.[103]

3. Part-Time Employees

In applying the benefits test to health plans, the employer may adjust the benefits provided to certain part-time employees.[104] First, if an employee normally works less than 22½ hours per week, the employer may deem benefits provided to have a value equal to twice that of the actual value of coverage provided. Second, if an employee normally works less than 30 hours per week, benefits provided may be deemed to have a value equal to up to 1½ times the actual value.

If the employer elects to use this special rule, it must be applied on a uniform nondiscriminatory basis for all employees.[105] Moreover, in applying the 50% component of the 90/50 test, the part-time employee rule applies to available benefits.[106] The rule will not apply for any purpose, however, in a plan year unless, during that year, more than 50% of the nonexcludable employees (determined *without* regard to plan provisions) work more than 30 hours per week.[107]

Note: The deemed increase in benefits due to the part-time employee rule does not apply to benefits provided pursuant to elective contributions.[108]

4. Coordination of Benefits

Sections 89(j)(9) and (10) provides rules regarding the coordination of a plan with health and disability benefits provided under any federal, state, or foreign law or any other health plan covering the employee or his or her family members.[109] If a plan is so coordinated, it will not fail to meet the nondiscrimination requirements regarding health benefits simply because the amount of those benefits are coordinated in a manner that does not discriminate in favor of highly compensated employees.[110]

In addition, in applying the nondiscrimination tests to health plans, the conferees authorized the Secretary to promulgate regulations disregarding state-mandated benefits in certain instances.[111] As an example, the Conference Report states that, when comparing state-mandated benefits, benefits that are mandated in one state but not in another may be disregarded.[112] Only ancillary, rather than core, benefits, however, may be disregarded.[113] Thus, if a state mandated an HMO option, the value of coverage under the HMO may not be disregarded.[114]

E. Special Group-Term Life Insurance Rule

In applying the benefits test and the 50% component of the 90/50% test to a group-term life insurance plan, the employer-provided benefit is defined as the cost of insurance provided in the plan year under §79(c) (*i.e.*, the Table I rates) for an individual who has attained age 40.[115] The benefit may be adjusted based on an employee's compensation, unless a group-term plan is aggregated with plans of a different type.[116] This adjustment is made by multiplying the benefit amount by a fraction. The numerator of the fraction is a uniform amount for all plans. The denominator is the employee's compensation.[117] For purposes of this rule, the Conference Report states that the TRA-enacted uniform definition of compensation for retirement and welfare benefit plan purposes applies.[118] Thus, compensation in excess of $200,000 shall *not* be taken into account in applying the benefits tests and the 50% component test.

F. Highly Compensated Employees

For purposes of the §89 nondiscrimination rules,[119] qualified tuition reduction programs, group legal services plans, cafeteria plans, educational assistance programs, §132 fringe benefits and welfare benefit funds,[120] the term "highly compensated employee" is defined under §414(q) (in the same manner as under the qualified plan provisions). Section 414(q) defines a highly compensated employee as an employee who, during the plan year or the previous plan year, was:

(1) a 5% owner of the employer;

(2) earned more than $75,000 (indexed for inflation) in annual compensation;

(3) earned more than $50,000 (indexed for inflation) in annual compensation and was in the top 20% of the employer's employees by compensation; or

[95] Act §1151(a) adding §89(g)(2)(B); Conference Report, p. II-513.
[96] Conference Report, p. II-513
[97] Conference Report, p. II-513.
[98] Act §1151(a) adding §89(g)(2)(C)(i).
[99] Act 1151(a) adding §89(g)(2)(C)(ii).
[100] Act §1151(a) adding §89(g)(2); Conference Report, p. II-513.
[101] Conference Report, p. II-513.
[102] Conference Report, p. II-513.
[103] *Id.*
[104] Act §1151(a) adding §89(j)(5); Conference Report, p. II-515.
[105] Conference Report, p. II-515.
[106] *Id.*
[107] Conference Report, p. II-515.
[108] Conference Report, p. II-515.
[109] Act §1151(a).
[110] Act §1151(a) adding §89(j)(9).
[111] Conference Report, p. II-515.
[112] Conference Report, p. II-515.
[113] *Id.*
[114] *Id.*
[115] Act §1151(a) adding §89(g)(3)(C)(i); Conference Report p. II-514.
[116] Conference Report, p. II-514.
[117] *Id.*
[118] *Id.*
[119] Act §1151(a) adding §89(j)(1).
[120] Act §1114(b); Conference Report, p. II-509.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(4) an officer of the employer within the meaning of §416(i) who received compensation greater than 150% of the dollar limit on annual additions to a defined contribution plan.[121]

An employee not considered highly compensated in the previous plan year, however, will not be considered highly compensated for the current plan year as a result either of officer status or of earning more than $50,000 or $75,000 unless the employee is also one of the top 100 employees of the employer in terms of compensation.[122]

In determining whether an employee is an officer, no more than 50 employees (or, if lesser, the greater of three employees or 10% of the employees) are to be treated as officers.[123] If no officer has compensation in excess of 150% of the defined contribution plan §415 dollar limit on annual additions for the year in question, the highest paid officer of the employer will be treated as an officer for purposes of determining which employees are highly compensated.[124] As in the case of the top-heavy plan rules, a partnership is considered to have officers for this purpose.[125] The determination of the identity and number of highly compensated employees is to be made on an employer-wide basis, rather than on a line of business or operating unit basis.[126]

For purposes of the definition of highly compensated employee, an employee is considered to be in the top-paid group if the employee is in the group consisting of the top 20% of employees ranked by compensation paid that year.[127] In determining the size of the top-paid group, the employer may exclude active employees who (1) have not completed six months of service; (2) normally work less than 17½ hours per week; (3) normally work during not more than six months during any year; (4) have not attained age 21; (5) are covered by a bona fide collective bargaining agreement; or (6) are nonresident aliens receiving no U.S. source income.[128]

The compensation of, and the benefits under, the plan for an individual who is a family member of either a 5% owner or one of the top 10 highly compensated employees are aggregated with the compensation and benefits of such 5% owner or highly compensated employee for purposes of determining whether the employee is a highly compensated employee.[129] Moreover, even if an employee is excluded for purposes of determining the number of employees in the top-paid group, such family members are still subject to this aggregation rule.[130] In the case of health benefits, however, where a family member would be aggregated with a 5% owner or one of the top 10 highly compensated employees, such family member shall be treated as a nonemployee family member.[131] "Family" for this purpose is defined as an employee's spouse and his lineal ascendants and descendants and their spouses.[132]

A former employee is treated as highly compensated if the employee was highly compensated on the date of separation from service or at any time after attaining age 55.[133] The Conference Report directs the Secretary to promulgate regulations treating an employee who continues to perform only *de minimis* services for the employer as separated from service for purposes of determining whether the employee is highly compensated.[134] In determining whether an employee is highly compensated, compensation within the meaning of §415(c)(3) is considered increased by elective contributions under a cafeteria plan, qualified cash or deferred arrangement, SEP and tax-sheltered annuity.[135]

The definition of highly compensated employees, for purposes of the employee fringe benefit rules, applies to years beginning after December 31, 1987.[136]

G. Excludable Employees

In applying the §89 nondiscrimination rules, the following employees may be excluded:

(1) employees who have not completed one year of service (six months in the case of core benefits under a health plan);

(2) employees working less than 17½ hours per week;

(3) seasonal employees normally working no more than six months during a year;

(4) employees who have not reached age 21;

(5) employees covered by collective bargaining; and

(6) nonresident aliens receiving no income from the employer which would constitute U.S. source income.[137]

For purposes of the one year/six month service requirement, an employee is excluded from consideration until the first day of the first day of the first month beginning after completion of the required period of service.[138] In excluding employees, the employer may substitute a shorter period of service, smaller number of hours or months, or lower age specified in the plan for purposes of the period of service, number of hours or months and age requirements, respectively.[139]

Except to the extent provided in regulations, however, an employee may not be excluded unless all employees in that category are excluded.[140] In addition, an exclusion (other than of nonresident aliens) must apply to all employee benefit plans of the employer of the same type.[141] In the case of a cafeteria plan, all benefits under the cafeteria plan

[121] The dollar limit on annual additions to a defined contribution plan currently equals $45,000.
[122] Act §1114(a) adding §414(q)(2).
[123] Act §1114(a) adding §414(q)(5)(A); Conference Report, p. II-446.
[124] Act §1114(a) adding §414(q)(5)(B); Conference Report, p. II-446.
[125] Conference Report p. II-446.
[126] Conference Report, p. II-446.
[127] Act §1114(a) adding §414(q)(4).
[128] Act §1114(a) adding §414(q)(8); Conference Report, p. II-447.
[129] Act §1114(a) adding §414(q)(6).
[130] Conference Report, p. II-447.
[131] Conference Report, p. II-517.
[132] Act §1114(a) adding §414(q)(6)(B).
[133] Act §1114(a) adding §414(q)(9); Conference Report, p. II-447.
[134] Conference Report, p. II-447; Senate Report, p. 557.
[135] Act §1114(a) adding §414(q)(7); Conference Report, p. II-448.
[136] Act §1114(c)(2).
[137] Act §1151(a) adding §89(h).
[138] Act §1151(a) adding §89(h)(1)(A).
[139] Act§1151(a) adding §89(h).
[140] Act §1151(a) adding §89(h)(2).
[141] Act §1151(a) adding §89(h)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

are treated as provided under plans of the same type.[142] These rules do not apply, however, to differences in waiting periods for core and noncore health benefits.[143] The rules described in this paragraph are to be applied separately to lines of business that are treated separately for purposes of §89(h)(5).[144]

The Act also provides that for purposes of testing any plan maintained by an employer, notwithstanding the rules described in the preceding paragraph, employees excludable under the *age and service* requirements of §89(h)(1) may be tested separately if such employees are covered under a plan of the employer which satisfies the requirements of §89 separately with respect to such employees.[145] In addition, the Conference Report provides employer also may elect to test a particular group of excludable employees separately provided that the group is defined in a nondiscriminatory manner, solely with reference to the age or service requirements.

If an employer aggregates plans of different types in order to satisfy the benefits test, the excludable employee provisions apply as though the plans were all of the same type.[146] Thus, for instance, the lowest age or service requirements in any one of the plans would apply.[147]

H. Separate Lines of Business

If the employer establishes to the Secretary's satisfaction that it operates separate lines of business or operating units for *bona fide* business purposes, the eligibility, benefits, and alternative tests may be applied separately to employees in each line of business.[148] The plan must be available, however, to a group of employees which qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated employees.[149]

To be considered a separate line of business, §414(r)(2) requires that three threshold conditions be met:

(1) the line of business must have at least 50 employees nonexcludable under §414(g)(8);

(2) the employer must notify the Secretary of its separate treatment; and

(3) the line of business meets the guidelines to be prescribed by regulations or the employer receives a determination from the Secretary that the line of business may be treated as separate.

Whether a separate line of business exists depends on the facts and circumstances.[150] In making this determination, differences between services provided and products produced by claimed separate lines are to be considered.[151] The employer's method of business organization also is relevant.[152]

More than one line of business or operating unit may be aggregated to satisfy the 50 employee requirement.[153] Section 414(r)(3) provides a safe harbor for a line of business if "the highly compensated employee percentages" with respect to the line of business is not less than one-half, nor more than twice, the percentage which highly compensated employees constitute of all employees of the employer. An employer is deemed to meet the 50% requirement if at least 10% of all highly compensated employees perform services solely for such line of business.[154] For purposes of the safe harbor, "highly compensated employee percentage" means the percentage which highly compensated employees performing services for the line of business comprise of all employees performing services for the line of business.[155]

The line of business rule, however, may not be used to circumvent the nondiscrimination tests.[156] Thus, certain job classifications, *e.g.*, hourly or leased employees, are not considered a separate line of business.[157] Moreover, secretaries and other support staff personnel would not comprise a separate line of business from the professional staff.[158] Further, members of an affiliated service group (within the meaning of §414(m)) may not be treated as separate lines.[159] In addition, an operating unit must operate in "a significantly separate geographic area from another operating unit in the same line of business.[160] Two plants in the same city, thus, could not be separate operating units.[161]

The Secretary is directed to promulgate regulations delineating the treatment of employees of a headquarters or home office.[162] The Conference Report clarifies that such employees are to be allocated to one line of business or an operating unit.[163] Such allocation, generally, will be in accordance with the performance of services.[164] Therefore, if the majority of an employee's services are performed for one line of business, the employee must be allocated to that business.[165]

Services provided by other employees for multiple lines of business are also to be allocated. The Conference Report provides that such an allocation is to be made in one of two ways.[166] First, employees may be allocated among lines of business on a pro rata basis in accordance with regulations to be prescribed.[167] Second, an employee may be allocated to any one line of business for which he performs substantial services, provided the allocation does not violate the

[142] *Id.*
[143] §89(h)(3)(B).
[144] §89(h)(4).
[145] §89(h)(5).
[146] Conference Report, p. II-521.
[147] *Id.*
[148] Act §1151(a) adding §89(g)(5); Conference Report, p. II-523.
[149] Act §1151(a) adding §89(g)(5).
[150] Conference Report, p. II-523.
[151] Conference Report, p. II-523-524.
[152] Conference Report, p. II-524.
[153] Conference Report, p. II-524.
[154] Act §1115(a) adding §414(r)(3).
[155] Act §1115(a) adding §414(r)(4).
[156] Conference Report, p. II-524.
[157] Conference Report, p. II-522.
[158] *Id.*
[159] *Id.*
[160] Conference Report, p. II-524.
[161] *Id.*
[162] Act §1115(a) adding §414(r).
[163] Conference Report, p. II-524.
[164] *Id.*
[165] *Id.*
[166] Conference Report, p. II-524.
[167] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

highly compensated percentage rule as described in the safe harbor.[168] Thus, if a line of business fails the 50% rule, highly compensated employees at headquarters not performing a majority of their services for a particular line of business must be allocated first to the failing line of business.[169] No highly compensated employee may be allocated, however, to a line of business if the allocation causes a violation of the 200% rule (regardless of whether a violation existed prior to the allocation).[170]

The Conference Report also provides that the Secretary should prescribe annual reporting rules for employers using the separate line of business rule.[171] The employer must include the basis for invoking the position. Moreover, if the employer has a separate line of business not falling within the safe harbor rule, that fact must be reported.[172]

The Conference Report directs the Secretary to establish guidelines outlining circumstances in which there is to be special scrutiny of lines of business.[173] As an example, the Conference Report states that, if a plan maintained for a separate line of business is significantly better or worse than that for another line of business, special scrutiny is required.[174] Another example is where a disproportionate amount of the accrued benefits under the plan of the separate line of business is for highly compensated employees.[175]

If a line of business does not satisfy the safe harbor rule and a plan of such business demands special scrutiny, the employer must obtain a determination from the Secretary that the line of business is separately operated for *bona fide* business purposes.

Moreover, if an employer uses the separate line of business rule all of its employees must be considered part of a line of business.[176] For instance, if an employer has 50 employees and 10 other employees not part of any line of business who would be separately tested, the 10 employees will be treated as part of some line of business. A line of business with only 10 employees, however, would need to be aggregated with another line to meet the 50 employee requirement.[177]

The Act also requires that benefits which are attributable to services for a line of business will be considered as provided by that line of business.[178] For purposes of the benefit rule, an employee performing services for more than one line of business who is allocated to one line of business is considered to provide services only for that line of business to which he is allocated.[179]

[168] *Id.*
[169] *Id.*
[170] Conference Report, pp. II-524-25.
[171] Conference Report, p. II-525.
[172] *Id.*
[173] *Id.*
[174] *Id.*
[175] *Id.*
[176] *Id.*
[177] *Id.*
[178] Act §1115(a) adding §414(r)(5); Conference Report, p. II-525. This benefit rule was substituted for the rule providing that if employees from more than one line of business are eligible to participate in a plan, all of those lines of business would be treated as one.
[179] Conference Report, p. II-525-26.

I. Definitions and Special Rules

1. Time for Testing

The benefits test, the 50% component of the 90/50% test and the comparability tests all are applied on the basis of benefits or coverage provided during the entire year.[180] The Conference Report provides an illustration of the appropriate time for testing.[181] Assume employee A becomes nonexcludable on July 1 and on that date A is covered under a health plan providing coverage valued at $1,000 annually. The plan year is the calendar year so, for that plan year, A receives only $500 of benefits. This $500 is included in the numerator in determining the average employer-provided benefit. The employee, however, is only counted as one-half an employee for purposes of the denominator, since A was only a nonexcludable employee for half of the year.[182] This rule, however, does not apply to group-term life insurance plans if the employer adjusts the value of the benefit based on the employee's compensation.[183]

The Conference Report also provides a rule of convenience for health plans and group-term life insurance.[184] For purposes of applying the benefits test to active employees, an employer may treat employees who separate from service during the last three months of the plan year as continuing to work and receive benefits for the rest of the plan year.[185] Employees separating from service earlier in the plan year may be treated as continuing to work and receive benefits through the end of the month in which they separate.[186] These rules will prevent an employer from having to know the exact date of separation for purposes of calculating the average employer-provided benefit.[187] An employer may deem an employee to have separated from service on only the last day of the month or, in the case of the last quarter, as of the end of the year. After separation, employees will be considered to receive whatever benefit they were receiving before separation so long as that benefit was provided for at least 90 days before the separation.[188] If benefits change during the 90-day period, the relevant figure is the average benefit as calculated from the date the employee first became subject to the nondiscrimination rules to the date of separation from service.[189] This rule of convenience also applies to the alternative 80% test, the 90% component of the 90/50 test, the 50% test and the benefits safe harbor test.[190] For purposes of the eligibility tests, however, employees who have separated from service are deemed to have available, after separation, the benefits available before separation.[191] This benefits rule, however, does not apply in testing benefits actually received by, or available to, former employees.[192]

[180] Act §1151(a) adding §§89(f), (g)(3)(A); Conference Report, p. II-526.
[181] Conference Report, p. II-526.
[182] *Id.*
[183] Conference Report, p. II-527.
[184] *Id.*
[185] *Id.*
[186] *Id.*
[187] *Id.*
[188] Conference Report, p. II-527.
[189] *Id.*
[190] *Id.*
[191] *Id.*
[192] *Id.*

An additional rule of convenience is provided for employees not requiring any initial period of service for participation in a statutory employee benefit plan (not just health or group-term life insurance plans).[193] For purposes of the benefits test and the 90/50 test, an employer may disregard benefits provided to an employee during the period between commencement of employment and the first day of the calendar month after employment commencement.[194] This rule does not apply, however, to employees who begin work on the first day of the month.[195] Benefits paid during this initial period cannot be disregarded, however, if they relate to another period. Thus, according to the Conference Report, if an employer during the initial period pays for a year's worth of dependent care or provides an annual physical examination, only a proportionate part of the value of such benefit may be disregarded.[196] If initial period rule of convenience is used, the employer must use it for all employees.[197]

2. Special Rules for Dispositions and Acquisitions

If an employer becomes, or ceases to be, a member of a controlled or affiliated service group (within the meaning of §§414(b), (c), (m) or (o)), the requirements of §89 will be deemed to have been satisfied during the "transition period" if:

(1) the §89 rules were satisfied immediately before the acquisition or disposition, and

(2) the coverage under the plan does not change significantly during the transition period (other than due to the disposition in acquisition).[198]

The transition period begins on the date of the disposition or acquisition and ends on the last day of the first plan year beginning after the transaction.[199]

3. Separate Plans

Each option or different benefit offered under a statutory employee benefit plan, including different levels of coverage, is treated as a separate plan and must be tested separately.[200] Coverage under health plans that have different limitations on family coverage are to be treated as separate plans, one plan for individual employee coverage and one for each of the family coverage options. Group-term life insurance coverage that varies in proportion to compensation not exceeding $200,000 is not be to be considered as different options or benefits with respect to varying coverage, unless the plan is aggregated with different types of plans.[201] Moreover, two or more health plans may be treated as a single plan if they are identical in all aspects except that the employer subsidy (not elective contributions) for part-time employees is proportionately reduced on an uniform, nondiscriminatory basis. More than 50% of the nonexcludable employees (determined without regard to plan provisions), however, must work more than 30 hours per week during the plan year in question for this part-time rule to apply.[202]

4. Valuation

The Secretary is directed to prescribe regulations regarding valuation of coverage. Regarding health coverage, values for various standard types of coverage will be set forth in tables establishing the relative values of plans with certain characteristics.[203] These tables can use an identifiable standard plan as a reference point.[204] The tables are to be adjusted to account for the specific group and coverage involved. For example, to determine the value of discriminatory coverage, the actual costs expended may be considered and allocated among all coverages, including discriminatory coverage, on the basis of their relative values, as determined under the prescribed tables.[205] Also, in certain cases, the table values of coverage may be adjusted if the coverage would have been provided at group rates by an insurance company.[206] The Conference Report provides that it would also be appropriate to reduce the table value if the same coverage is provided under more than one plan.[207]

Special rules apply to group-term life insurance.[208] If coverage is found to be discriminatory, however, discriminatory coverage will be valued at the higher of §79(c) table cost or actual cost.[209]

5. Former Employees

The Act provides that, except to the extent provided in regulations, the nondiscrimination tests also apply to former employees.[210] The legislative history suggests that the class of former employees to be tested may be restricted to those employees who have separated from service due to disability or who have retired on or after a reasonable retirement age.[211] Further, employers may limit the class to employees who have retired within a specific time.[212] Reasonable assumptions regarding mortality may be made so that the employer need not determine if former employees are still alive.[213]

6. Self-employed Persons

Self-employed individuals are treated as employees and their earned income is treated as compensation for purposes of applying the nondiscrimination rules to qualified group legal service plans, educational assistance programs and dependent care assistance programs electing statutory employee benefit plan treatment.[214] A sole proprietor is treated as his own employer and a partnership is treated as the employer of each partner.[215]

---

[193] *Id.*
[194] *Id.*
[195] Conference Report, p. II-527-28.
[196] *Id.*
[197] *Id.*
[198] Act §1151(a) adding §89(j)(8); Conference Report, p. II-529.
[199] *Id.*
[200] Act §1151(a) adding §89(j)(11).
[201] Act §1151(a) adding §89(j)(4).
[202] Conference Report, p. II-530-31.
[203] Conference Report, p. II-532.
[204] *Id.*
[205] Conference Report, p. II-532-33.
[206] Conference Report, p. II-533.
[207] *Id.*
[208] *Id.*
[209] *Id.*
[210] Act §1151(a) adding §89(j)(3).
[211] House Report, p. II-534
[212] Conference Report, p. II-534.
[213] *Id.*
[214] Act §1151(a) adding §89(j)(6).
[215] *Id.*

7. Cafeteria Plans

The Act amends the definition of a cafeteria plan to include a plan under which a participant may elect only between qualified benefits in addition to a plan where a participant may elect between cash and qualified benefits.[216] As under pre-1986 TRA law, a cafeteria plan generally may not include a deferred compensation plan (except for profit-sharing or stock bonus plans that include a qualified cash or deferred arrangement.[217] Plans maintained by §170(b)(1)(A)(ii) educational organizations, however, may include such arrangements to the extent that an employee elects to have the employer pay contributions for post-retirement group life insurance if (1) all contributions for the insurance are made before retirement, and (2) such life insurance does not have a cash surrender value at any time. For purposes of §79, any such insurance is treated as group-term life insurance.[218]

The Act retains the pre-TRA law cafeteria plan eligibility test while changing the applicable benefits test. Under the revised benefits test, the qualified benefits provided to key employees (as defined by §416(i)) cannot exceed 25% of the aggregate of such benefits for all employees under the plan.[219]

Option elections by highly compensated employees, as defined by §414(q), can be limited by the employer so that the nondiscrimination rules are satisfied.[220] The Secretary is to prescribe regulations governing the imposition of these limits.[221] These regulations will ensure that the limits are applied in a nondiscriminatory manner which is consistent with the manner in which the discriminatory excess is allocated under §89, discussed, *supra.*

The Act also makes the following uniform definitions applicable to statutory employee benefit plans to cafeteria plans:

(1) highly compensated employees;

(2) excludable employees; and

(3) employer, including the definition of a leased employee.[222]

The Act also provides for coordination of the revised cafeteria plan provisions with employment tax provisions.[223]

8. Welfare Benefit Funds

For welfare benefit fund benefits not subject to any of the 1986 TRA nondiscrimination tests, the pre-TRA law nondiscrimination tests have been retained.[224] The following uniform definitions applicable to statutory employee benefit plans were also applied to welfare benefit funds:

(1) highly compensated employees;

(2) compensation (including the limitation on the amount which may be taken into account) with respect to life insurance, disability, severance pay and supplemental unemployment compensation,

(3) excludable employees; and

(4) employer (including the application of the leased employee rules).[225]

The Secretary is also directed to promulgate regulations regarding which nonemployees who participate in a plan will be regarded as highly compensated.[226]

J. Effective Dates

The general effective date of the nondiscrimination rules is for plan years beginning after the later of:

(1) December 31, 1987 or

(2) the earlier of (a) December 31, 1988, or (b) the date which is three months after the issuance of regulations under §89.[227]

The effective date for plans maintained pursuant to a collective bargaining agreement ratified before March 1, 1986, is the first plan year beginning *before* the earlier of

(1) the date on which the last of the collective bargaining agreements terminates, as determined without regard to any extension of such agreements made after February 28, 1986, or

(2) January 1, 1991.[228]

If the plan covers employees covered by the collective bargaining agreement and employees not covered by such an agreement, employees covered by the agreement are disregarded for purposes of the nondiscrimination rules until the rules are effective for such employees.[229]

Church plans, as defined by §414(e)(3), which maintain insured health or group-term life insurance plans need not comply with the nondiscrimination rules until plan years beginning after December 31, 1988.[230]

A special rule also applies to group-term life insurance plans which were exempt from the modifications made to the nondiscrimination rules by §223(d)(2) of the Tax Reform Act of 1984.[231] Individuals covered under such plans may be disregarded in applying the nondiscrimination rules to other employees. Thus, in testing a plan in existence on January 1, 1984 (or a comparable successor plan), employees who attained age 55 on or before January 1, 1984 and were either employed by the employer in 1983 or retired from employment with the employer on or before January 1, 1984, may be disregarded.[232]

---

[216] Act §1151(d)(1) amending §125(c)(1)(B).
[217] Act §1151(d)(1) amending §125(c)(2).
[218] Act §1151(a) amending §125(c)(2)(C).
[219] Act §1151(d)(1) amending §125(b)(2).
[220] Conference Report, p II-535.
[221] *Id.*
[222] Act §1151(d)(1) amending §§125(b)(3), (d); Conference Report, p II-535.
[223] Act §1151(d)(2).
[224] Conference Report, p. II-536.
[225] *Id.*
[226] *Id.*
[227] Act §1151(k)(1).
[228] Act §1151(k)(2).
[229] Act §1151(k)(2).
[230] Act §1151(k)(4).
[231] Act §1151(k)(3).
[232] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The rules coordinating the application of the revised cafeteria plan provision with the employment tax rules are effective for taxable years beginning after December 31, 1983.[233]

IV. Technical Corrections to Welfare Benefit Plan Provisions

A. Reserves for Discriminatory Post-Retirement Benefits

Under pre-TRA law, no reserve could be taken into account in computing the account limit regarding post-retirement medical or life insurance benefits under a plan not meeting the §505 nondiscrimination standards. The Act provides that no reserve is taken into account in determining the account limit for a welfare benefit fund ("WBF") for post-retirement medical or life insurance benefits unless the plan meets the §505(b) nondiscrimination requirements regarding those benefits.[234] The Act also clarifies that certain post-retirement group-term life insurance benefits failing to satisfy §505(b) may be taken into account to the extent that the group-term benefits are provided under a grandfathered arrangement.[235]

B. Actuarial Certification

For §505 purposes, the account limit for a "qualified asset account" is generally the amount reasonably and actuarially necessary to fund incurred, but unpaid, claims for benefits with respect to which the account is maintained. The Act extends the actuarial certification requirement to post-retirement medical and insurance benefits.[236]

C. Aggregation of Funds

Pre-1986 TRA law did not specify that the dollar limits applicable to life insurance benefits and supplemental unemployment compensation benefits or severance pay benefits apply to the aggregate of reserves under all funds of an employer, rather than on a fund-by-fund basis. Moreover, it was not specified that the limit on reserves is to be applied to the aggregate of insured and self-insured benefits. The Act provides that, in computing the dollar limits applicable to the amount of reserves for disability benefits, post-retirement medical benefits or insurance benefits for which reserves may be accumulated, all WBFs of an employer are aggregated and treated as a single fund.[237]

D. Definition of Fund

Under pre-1986 TRA law, a fund was defined as any tax-exempt social club, voluntary employees' beneficiary association (VEBA), supplemental unemployment compensation benefit trust (SUB), or group legal services organization; any trust, corporation or other organization not exempt from tax; and, to the extent provided in regulations, any account held for any employer by any person. Moreover, if an employer contributed amounts to an insurance company for benefits and was entitled to a rebate and was liable if the benefit claims exceeded the amount paid, the contributions were considered to have been made to a WBF. Further, an employer was not allowed a deduction for premiums paid on a life insurance policy covering the life of any officer, employee or person financially interested in the employer, where the employer was the direct or indirect beneficiary of the policy.

The Act amended the definition of fund to exclude amounts which are held under three types of insurance arrangements:

(1) §264(a)(1) insurance contracts;

(2) certain "qualified nonguaranteed contracts;" and

(3) certain "guaranteed renewal contracts."[238] A "qualified nonguaranteed contract" is an insurance contract under which (1) there is no guarantee of renewal, and (2) other than current insurance protection, the only payments to which the employer or employees are entitled are nonguaranteed refunds or policy dividends that are experience rated and determined by factors other than the amount of welfare benefits paid to employees or their beneficiaries.[239]

The Act also provides that, except in the case of a reserve for post-retirement medical or life insurance benefits and any other arrangement between an insurance company and an employer under which the employer has a contractual right to an experience based refund or dividend, any account held for an employer by any person and defined as a fund under regulations issued under §419(e)(3)(C) shall be considered a fund no earlier than six months following the date on which final regulations are published.[240]

E. Tax on Unrelated Business Income

Under the 1984 TRA, the tax on unrelated business income of a social club, VEBA, SUB or group legal service organization applies to an amount equal to the lesser of the income of the fund or the amount by which the assets in the fund exceed a specific limit on amounts set aside for exempt purposes. Limits are also imposed on the amounts that may be set aside in a given year. The limit on the amount that may be set aside for purposes of the unrelated business income tax does not apply to certain existing reserves for post-retirement medical or life insurance benefits. This exclusion applies to income which is attributable to the amount of assets, as of the close of the last plan year ending before July 18, 1984. Similar amounts, deemed unrelated income, are included in the gross income of an employer maintaining a nonexempt WBF.

The Act clarifies that the transition rule for pre–existing reserves for post-retirement medical or life insurance benefits applies to assets set aside *as of* July 18, 1984, rather than to assets set aside as of the end of the plan year ending before July 18, 1984.[241] The Act also deletes §512(a)(3)(E)(ii) barring a set aside for assets used in the provision of permissible benefits (facilities).[242] The House

[233] Act §1851(k)(5).
[234] Act §1851(a)(3) amending §419A(e).
[235] *Id.*
[236] Act §1851(a)(5) amending §419A(c)(5).
[237] Act §1851(a)(6) amending §419(A)(h); House Report, p. 983.
[238] Act §1851(a)(8)(A) amending §419(e).
[239] Act §1851(a)(8)(A) amending §419(e); House Report, p. 979.
[240] Act §1851(a)(8)(B).
[241] Act §1851(a)(10) amending §512(a)(3)(E); House Report, p. 985.
[242] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Report states that regulations are to provide that the value of facilities used to provide permissible benefits is disregarded in determining whether fund assets exceed the account limit for a qualified asset account.[243] Moreover, if any amount included in the gross income of an employer is deemed unrelated business income respecting a WBF, the amount of tax thus imposed is treated as a contribution to the fund on the last day of the taxable year and, thus, is deductible within normal limits.[244]

F. Tax on Disqualified Benefits

If a WBF (funded other than exclusively by employee contributions) provides a disqualified benefit during a taxable year, an excise tax equal to 100% of the disqualified benefit is imposed for that year on each employer maintaining the fund. A disqualified benefit is:

(1) any medical or life insurance benefit provided respecting a key employee other than from a separate account required under the rules limiting employer deductions;

(2) any post-retirement medical or life insurance benefit unless the plan meets the requirements of the applicable nondiscrimination rules; and

(3) any portion of a WBF reverting to the benefit of the employer.

A portion of a WBF is not considered to revert to the benefit of an employer simply because it is applied, in accordance with the plan, to provide welfare benefits to employees or their beneficiaries. Moreover, amounts returned to employees representing employer contributions are not treated as reverting to the benefit of the employer.

The Act defines "disqualified benefit" as any post-retirement medical or life insurance benefit provided with respect to a key employee if a separate account must be established and the payment is not from that account.[245] Moreover, any post-retirement medical or life insurance benefit provided respecting an individual in whose favor discrimination is prohibited is a disqualified benefit unless the §505(b) nondiscrimination rules are satisfied.[246] If a plan is not exempt from the discrimination rules under the rules applicable to collectively bargained plans, a discriminatory benefit is a disqualified benefit subject to the excise tax even though no discrimination test applies in determining the exempt status of the fund.[247] In addition, a payment reverting to the employer is not a disqualified benefit to the extent it is attributable to either (1) an employer contribution for which no deduction was allowed in the current or preceding year or (2) an employee contribution.[248] The Act also provides that an otherwise disqualified benefit is not a disqualified benefit if it is a post-retirement benefit (as defined by §512(a)(3)(E)) charged against an existing reserve for post-retirement medical or life insurance benefits.[249]

G. Effective Dates

The Act clarifies that the 1984 TRA rules relating to the excise tax on disqualified benefits generally apply to benefits provided after December 31, 1985.[250] The Act also clarifies that the amendments made by the 1984 TRA with respect to the unrelated business income tax are effective for taxable years ending after December 31, 1985.[251]

H. Fully Vested Vacation Pay Plans

The Act provides a transition rule in the case of a fully vested vacation pay plan in which payments are required within one year after the accrual of the vacation.[252] Moreover, if the taxpayer makes a §463 election for the taxpayer's first taxable year ending after July 18, 1984, then, in lieu of establishing a suspense account under §463, the election is treated as a change in the taxpayer's method of accounting and the adjustments under §481 are taken into account.[253] The time for making the §463 election is extended to six months after enactment of the 1986 TRA for a taxpayer otherwise eligible for the transition rule.[254]

V. Continuation Health Coverage Under the Consolidated Omnibus Budget Reconciliation Act (Technical Corrections) of 1985

A. Introduction

As part of the Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272), with some exceptions, employers that maintain health benefits plans for their employees are required to continue providing those benefits for a period of time for their employees and their dependents following certain qualifying events such as death, divorce, termination of employment or a reduction in hours. In general, the provisions apply only to employers with 20 or more employees and exclude certain church employers and the Federal government.

1. Scope of Continued Coverage

COBRA requires continued employer-provided health benefits for employees, spouses of employees and dependent children following a "qualifying event."

A "qualifying event" is one of five situations which would otherwise cause a loss of coverage under the plan, *i.e.*: (1) the death of the employee; (2) the termination of the employee's employment (other than for gross misconduct) or a reduction in the employee's hours; (3) the divorce or legal separation of the employee from the employee's spouse; (4) the employee's entitlement to Medicare; or (5) a dependent child ceasing to be a dependent under the generally applicable requirements of the plan.

2. Length of Continued Coverage

Where an employee is terminated or his hours are reduced so that he would otherwise no longer be entitled to health benefits, coverage must continue for at least 18

[243] House Report, p. 985.
[244] Act §1851(a)(9) amending §419A(g).
[245] Act §1851(a)(11) amending §4976(b); House Report, p. 986.
[246] *Id.*
[247] *Id.*
[248] *Id.*
[249] *Id.*
[250] Act §1851(a)(12).
[251] *Id.*
[252] Act §1851(b); House Report, p. 988.
[253] *Id.*
[254] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

months after the qualifying event. For any other qualifying event, coverage must continue for 36 months.

In general, under the pre-1986 TRA provisions, the required coverage could terminate earlier than the 18- or 36-month period if any of the following occured:

a. the group health plan is terminated;

b. coverage ceases due to the failure to make timely payment of premiums required under the plan;

c. a spouse or child of the employee becomes a covered employee under another group health plan or becomes entitled to Medicare benefits; and

d. if the beneficiary is the spouse, he or she remarries *and* becomes covered under a group health plan.

3. Type of Coverage

Under COBRA, continued coverage benefits must be identical to the benefits provided under the health plan to other similarly situated employees and beneficiaries with respect to whom a qualifying event has not occurred. Continued coverage may not be based on evidence of insurability.

4. Premium Requirements

The employer does not have to pay for the extended coverage; the plan may require that the employee or beneficiary pay the premium. The premium, however, may not exceed 102% of the cost to the plan for the period of coverage for similarly situated employees or beneficiaries with respect to whom a qualifying event has not occurred. Whoever pays the premium may elect to pay it in monthly installments.

COBRA contains special rules for establishing premiums for self-funded plans. The premium must be equal to a reasonable estimate of the cost of providing coverage to similarly situated employees and beneficiaries determined on an actuarial basis and taking into account factors which will be set forth in regulations.

The health plan must also provide the employee or beneficiary the option to enroll under a conversion health plan (if otherwise available under the plan) during the 180-day period immediately following the end of the extended coverage period.

5. Notice of and Election for Continued Coverage

A group health plan must provide, at the time health plan coverage begins or the COBRA provisions take effect, written notice to each employee and spouse of his or her rights to elect continued coverage upon the occurrence of qualifying events. This means, for example, that a plan with a June 30 fiscal year must advise employees and spouses of their rights to extended coverage before July 1, 1986.

After plan participation begins, the employer must notify the plan administrator (if other than the employer) of certain specified events requiring an extended coverage election. Employees and beneficiaries are responsible for notifying the plan administrator of other qualifying events. Specifically, the employer must notify the plan administrator of the death, termination of employment or reduction in hours, or eligibility for Medicare of any employee within 30 days of each event, while the employee (or, where appropriate, the beneficiaries) must notify the administrator of events such as divorce, separation, or a dependent child's ceasing to qualify as a dependent. The administrator must renotify the employee or beneficiaries of their continuation rights within 14 days after the administrator is notified of the qualifying event.

In general, each employee or beneficiary must be provided with an opportunity to elect continued coverage under the plan. The election period must last for 60 days and must begin no later than the date on which the coverage would terminate under the plan as a result of the qualifying event.

6. Exceptions

The COBRA rules do not apply to a group health plan if the employer maintaining the plan "normally" employed fewer than 20 employees on a typical business day during the preceding calendar year. All employers maintaining the plan must be aggregated and if, in the aggregate, all the employers employed fewer than 20 employees, the rules do not apply.

There are also exceptions for plans maintained by churches, the federal government, the District of Columbia and any territory or possession of the United States. Plans established and maintained by state and local governments that receive funds under the Public Health Service Act are covered by the COBRA provisions except that there is no statutory penalty imposed for failure to comply.

7. Consequences of Failure to Comply With the COBRA Requirements

The failure to provide the continued coverage required by COBRA will result, under Code §162(k), in a denial of the federal income tax deduction for expenses paid or incurred for any group health plan maintained by the employer. Also, highly compensated individuals who participate in a plan for which the employer fails to follow the COBRA requirements, will not be permitted to exclude from income the amount contributed by the employer in his or her behalf. In addition, for those plans covered by ERISA, a penalty of up to $100 per day may be imposed for failure to provide the required notices.

Although there are no tax or ERISA *per diem* penalties for the failure of a state or local government (or instrumentalities thereof) to comply with COBRA, that Act authorizes any aggrieved individual to bring an action against the state or locality for appropriate equitable relief.

8. Effective Date

In general, COBRA applies to plan years beginning on or after July 1, 1986. For example, the provisions apply to calendar year plans starting January 1, 1987.

In the case of a plan that is maintained pursuant to collective bargaining agreement, COBRA applies to plan years beginning after the later of January 1, 1987, or the date on which the last of the collective bargaining agreements relating to a particular plan terminates.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. Overview

The 1986 Tax Reform Act makes several changes to COBRA's continuation health care provisions. The same changes, with a few minor exceptions, are made to the Internal Revenue Code, ERISA, and the Public Health Service Act. Essentially, the changes provide additional guidance concerning notification requirements, the maximum allowable period of continuation coverage, the election of coverage, the failure to pay premiums, and the type of coverage that is required under COBRA.

C. Detailed Analysis

1. Modifications of Plan Coverage

In general, COBRA requires that each qualified beneficiary who would lose coverage under an employer-provided health plan as a result of a "qualifying event" be entitled to elect, within a prescribed period, continuation coverage under the plan. The coverage must consist of coverage which, as of the time it is provided, is identical that provided under the plan to similarly situated beneficiaries with respect to whom a qualifying event has not occurred.[255] The 1986 Act clarifies that, if coverage under the plan is modified for any group of similarly situated beneficiaries, the coverage must also be modified in the same manner for all individuals who are qualified beneficiaries under the plan receiving continuation coverage.[256]

The Conference Report provides, as an example, that if the plan provides for an open enrollment, then qualified beneficiaries are to be permitted to make elections during the open enrollment period in the same manner as active employees. As a result, an individual who is a qualified beneficiary by reason of being a spouse of a covered employee, would have the same rights as active employees during an open enrollment period and would not be limited to the rights of spouses of covered employees.[257]

2. Maximum Required Period of Continuation Coverage

COBRA requires that continuation coverage continue for 18 or 36 months, depending on the nature of the qualifying event. For example, if the qualifying event is a termination of employment, the continuation coverage must be provided for 18 months. If, however, the qualifying event is the death of the employee-spouse, however, continuation coverage may have to be provided for up to 36 months.[258] Following the enactment of COBRA, there was confusion concerning the required length of coverage where two qualifying events occur, one of which requires 18 months of coverage and the other, 36 months. The Act clarifies that the maximum amount of coverage that must be provided from the date of the first qualifying event is 36 months of coverage.[259] To be eligible for a total of 36 months of continuation coverage beginning on the date of the first qualifying event, the second qualifying event must take place during the period of coverage of the first qualifying event.[260]

3. Grace Period for Payment of Premiums

COBRA provides that the maximum period required for coverage may be reduced if there is a failure to make "timely payment" of any premium required under the plan with respect to a qualified beneficiary.[261] COBRA, however, did not establish a time frame in which a failure to pay premiums would be deemed to be a failure to make timely payment. As a result, it was unclear when continuation coverage should terminate due to failure to pay premiums. The Act clarifies that the payment of premiums will be considered timely if made within 30 days after the due date or within a longer period if the plan permits a longer period in which to pay premiums.[262] The Conference Report adds that the period may be extended to include the period an insurance company allows the plan or the employer for failure to pay premiums.[263]

4. Termination of Continuation Coverage Upon Coverage by Another Group Health Plan Rather Than Upon Reemployment or Remarriage

Under pre-1986 TRA law, an event that terminated continuation coverage was the remarriage of the qualified beneficiary and the coverage of that beneficiary under another group health plan. Another event under pre-TRA law that terminated continuation coverage was the coverage of the qualified beneficiary under any other group health plan, or his or her entitlement to benefits under Medicare (Title XVIII of the Social Security Act). The Act modifies these COBRA provisions by providing that a termination of continuation coverage occurs when the qualified beneficiary becomes covered under any other group health plan regardless of whether there is a remarriage or whether the individual is the covered employee, a spouse or a dependent under the new group health plan.[264]

5. Clarification Relating to Election by Beneficiaries

The Act provides that if there is a choice among types of coverage under the plan, each qualified beneficiary is entitled to make a separate selection among such types of coverage.[265] The Conference Report states that if the covered employee does not elect continuation coverage, the spouse or dependent child is entitled to elect the coverage. Even if the employee elects certain coverage, the spouse or a dependent may elect different coverage.[266]

6. Notice Requirements

COBRA provided that each covered employee or qualified beneficiary must notify the plan administrator of the occurrence of certain qualifying events. COBRA, however,

---

[255] Code §162(k)(2)(A), ERISA §602(1), PHSA §2202(1).
[256] Act §1895(d)(1); amending Code §162(k)(2)(A), ERISA §602(1).
[257] Conference Report, p. II-859.
[258] Code §162(k)(2)(B), ERISA §602(2)(A), PHSA §2202(2).
[259] Act §1895(d)(2), amending Code §162(k)(2)(B), ERISA §602(2)(A) and PHSA §2202(2)(A).
[260] Conference Report, p. II-859.
[261] Code §162(k)(2)(B)(iii), ERISA §602(2)(C), PHSA §2202(2)(C).
[262] Act §1895(d)(3), amending Code §162(k)(2)(B), ERISA §602(2)(C), and PHSA §2202(2).
[263] Conference Report, p. II-859.
[264] Act §1895(d)(4), amending Code §162(k)(2)(B), ERISA §602(2) and PHSA §2202(2).
[265] Act §1895(5), amending Code §162(k)(2)(B), ERISA §605(2) and PHSA §2205(2).
[266] Conference Report, p. II-859.

did not set a period within which the notification must take place.

The Act imposes a 60-day notification period in which divorced or legally separated spouses of covered employees, or dependent children ceasing to be dependent children under the generally applicable requirements of the plan, must notify the plan administrator of a qualifying event entitling the spouse or dependent child to continuation health care coverage.[267] The provision is effective with respect to qualifying events occurring after the 1986 TRA's date of enactment.[268]

7. Nonresident Aliens

The Act also contains an exception from the continuation coverage requirements for nonresident aliens. It provides that the term "qualified beneficiary" does not include an individual whose status as a covered employee is attributable to a period in which the individual was a nonresident alien who received no earned income (within the meaning of Code §911(d)(2)) from the employer which constituted income from sources within the United States (within the meaning of Code §61(a(3). The Act further provides that if an individual is not a qualified beneficiary pursuant to the previous sentence, the spouse or dependent child of the individual is also not considered a qualified beneficiary by virtue of the relationship to the individual.[269]

8. ERISA Definition of "Group Health Plan"

For ERISA purposes, COBRA defined group health plan as an employee welfare benefit plan within the meaning of Code §162(i)(3) which, in turn, references the definition of Code §213(d). The Act revises this definition to directly key it to Code §213(d).[270] While the purpose of this provision appears to have been purely technical, the Conference Report indicates that health benefits include dental and vision care (within the meaning of Code §213). The Conference Report also indicates that Congress did not intend that an employer could compel a qualified beneficiary to pay for non "core" benefits (such as dental and vision care) even if active employees are required to purchase coverage for such benefits under the plan.[271]

9. Aggregation Rules for Employers Under ERISA

The Act adds a new definition of "employer" to the ERISA continuation health benefits provisions. This definition provides that the term includes a controlled group of employers. Specifically, it provides that the leased employee rules of Code §414(n) and the controlled group rules of Code §414(t) (as added by the Act) apply for purposes of continuation health benefits in the same manner and to the same extent as they apply for purposes of Code §106. Furthermore, any regulations prescribed by the Secretary of the Treasury with regard to those Code provisions will be consistent and coextensive with any regulations prescribed by the Secretary of the Treasury.[272] The effective date for the provision is the same as for the Act's amendments to Code §414 involving controlled groups and leased employees.[273] In general, the rules will apply no later than for years beginning after December 31, 1988, although they may apply earlier if the Secretary of the Treasury issues regulations before that date, but, in no event will they apply earlier than for years beginning after December 31, 1987 or three months after the Secretary of the Treasury issues regulations.[274] There are special rules for collectively bargained plans.[275]

10. Effective Date

In general, unless otherwise indicated above, the effective date for the changes in the Act applicable to continuation health benefits are effective as if they were included in the enactment of the Consolidated Omnibus Budget Reconciliation of 1985.[276]

---

[267] Act §1895(d)(6), amending Code §162(k)(6)(C); ERISA §606(3); PHSA §2206(3).
[268] Act §1895(d)(6)(D).
[269] Act §1895(d)(7).
[270] Act §1895(d)(8).
[271] Conference Report, p. II-859.
[272] Act §1895(d)(9), adding ERISA §607(4).
[273] Act §1895(d)(9)(B). *See* Act §1151(e) and (i).
[274] Act §1151(k)(1).
[275] Act §1151(k)(2).
[276] Act §1895(d)(9)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 54

NEW OR REVISED QUALIFICATION REQUIREMENTS FOR QUALIFIED PLANS

Taina E. Edlund, Esq.
Diane J. Fuchs, Esq.
Stuart M. Lewis, Esq.
Marilyn E. Nelson, Esq.
Silverstein and Mullens
Washington, D.C.

I. Qualified Plan Coverage Rules and Related Provisions

A. Introduction

In enacting §§1111 through 1115 of the Tax Reform Act of 1986, Congress generally sought to ensure that a larger number of employees would enjoy qualified plan coverage and that their benefits would become nonforfeitable earlier than under pre-TRA law. Under pre-TRA law, qualified plans satisfied the minimum coverage requirements if they benefited a certain specified percentage of employees or benefited a classification of employees which did not discriminate in favor of officers, shareholders or highly compensated employees. The term "highly compensated employee" was not statutorily defined. To ensure that employees with substantial benefits did not lose plan benefits upon separation from service, a qualified plan was required to provide that (1) benefits vest upon a participant's attainment of normal retirement age, (2) the participant was always vested in his employee contributions and (3) in general, benefits vested in accordance with one of three statutory "regular" vesting schedules. Section 411(a) delineated these three vesting options. Under the first option, full vesting was required upon completion of 10 years of service. Under the second option, known as "graded" vesting, vesting began at 25% after five years of service and increased in statutory increments to 100% after 15 years. Under a third option, known as "rule of 45" or "age-related" vesting, both age and service could be considered, provided that there was 50% vesting after 10 years of service with an additional 10% per year until 100% vesting was reached after 15 years of service. Special vesting rules applied to "class year" plans. Special rules also applied under Code §401(a)(5) and various IRS revenue rulings in determining whether defined contribution and defined benefit plans were integrated with social security benefits in a nondiscriminatory manner.

B. Overview

The 1986 TRA revised the qualified plan minimum coverage requirements,[1] imposed an additional minimum participation standard,[2] introduced a uniform definition of highly compensated employee,[3] which provides that the qualified plan and employee benefit plan nondiscrimination rules can be satisfied on a separate line of business or operating unit basis,[4] redefined compensation,[5] modified the integration rules for qualified plans to restrict Social Security integration,[6] tightened the qualified plan regular vesting provisions,[7] and repealed class year vesting.[8]

These amendments are generally effective for plan years beginning after 1988. The provisions adding the definitions of highly compensated employee, separate lines of business and compensation are generally effective for years beginning after 1986.

C. Detailed Analysis

1. Highly Compensated Employees

a. Definition

The Act added §414(q) which defines a highly compensated employee for qualified plan purposes. The definition, with a different effective date, also applies to certain code fringe benefit provisions. Under the revised definition, a highly compensated employee is defined as an employee who, during the plan year or the previous plan year,

(a) was a 5% owner of the employer;

(b) earned more than $75,000 (indexed for inflation) in annual compensation;

(c) earned more than $50,000 (indexed for inflation) in annual compensation and was in the top 20% by compensation; or

(d) was an officer of the employer within the meaning of §416(i) and received annual compensation greater than 150% of the applicable year's §415 dollar limit on annual additions to a defined contribution plan.[9]

[1] Act §1112(a) amending §410(b). All section references herein are to the Internal Revenue Code of 1986 unless otherwise specified.

[2] Act §1112(b) adding §401(a)(26).
[3] Act §1114(a) adding §414(q).
[4] Act §1115(a) adding §414(r).
[5] Act §1115(a) adding §414(s).
[6] Act §1111(a) amending §401(l).
[7] Act §1113(a) amending §411(a)(2).
[8] Act §1113(b) repealing §411(d)(4).
[9] The dollar limit on annual additions to a defined contribution plan for 1986 equals $45,000.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

An employee not considered highly compensated in the previous plan year, however, will not be considered highly compensated for the current plan year as a result of either of officer status or of earning more than $50,000 or $75,000 unless the employee is also one of the top 100 employees by compensation.[10]

In determining whether an employee is an officer, no more than 50 employees (or, if lesser, the greater of three employees or 10% of the employees) are to be treated as officers.[11] If no officer has compensation in excess of 150% of the year's §415 defined contribution plan dollar limit, the highest paid officer of the employer will be treated as an officer for purposes of the highly compensated employee rules.[12] As in the case of the top heavy plan rules, a partnership is considered to have officers.[13] Moreover, the determination of the identity and number of highly compensated employees is made on an employer-wide basis, rather than on a line of business or operating unit basis.[14]

For purposes of the definition, an employee is considered to be in the top-paid group if he is in the group consisting of the top 20% of employees ranked by compensation paid that year.[15] In determining the size of the top-paid group, the employer may exclude active employees who (1) have not completed six months of service; (2) normally work less than 17½ hours per week; (3) normally work during not more than six months during any year; (4) have not attained age 21; (5) are covered by a bona fide collective bargaining agreement; or (6) are nonresident aliens receiving no U.S. source income.[16]

The compensation of, and the benefits under, the plan for an individual who is a family member of either a 5% owner or one of the top 10 highly compensated employees are aggregated with the compensation and benefits of the 5% owner or the highly compensated employee for purposes of determining who is a highly compensated employee.[17] Moreover, even if an employee is excluded for purposes of determining the number of employees in the top-paid group, such family member still is subject to the aggregation rule.[18] "Family" is defined as an employee's spouse and his lineal ascendants and descendants and their spouses.[19]

A former employee is treated as highly compensated if he was highly compensated on the date of separation from service or at any time after he attained age 55.[20] The Conference Report directs the Secretary to promulgate regulations treating an employee who continues to perform only de minimis services for the employer as having been separated from service for purposes of determining whether the employee is highly compensated.[21] Further, in determining whether an employee is highly compensated, compensation within the meaning of §415(c)(3), increased by elective contributions under a cafeteria plan, qualified cash or deferred arrangement, a SEP and a tax-sheltered annuity, is considered.[22]

The definition of highly compensated employee applies for purposes of §§79, 89, 106, 117(d), 120, 127, 129, 132, 274, 401(a)(4), 401(a)(5), 401(k)(3), 401(l), 401(m), 406(b), 407(b), 408(k), 410(b), 411(d), 414(m), 415(c), 423(b), 424(c), 501(c)(17), 501(c)(18), 505 and 4975 and 29 U.S.C. §1108.

b. Effective Date

The §414(q) definition of highly compensated employee generally applies to years beginning after December 31, 1986.[23] If, however, the substantive provision to which the definition relates is effective at a later date, the definition will be effective as of such later date.[24] The definition applies to employee benefit plans in years beginning after 1987.[25] The definition applies to the pension provisions effective for years beginning after 1988.[26] For purposes of §401(k) and §401(m), a special rule applies in the case of an employer incorporated on December 15, 1924.[27] If more than 50% of its employees in the top-paid group earn less than $25,000 (indexed for inflation), then the highly compensated employees include employees described in §414(q)(1)(C), determined without regard to the level of compensation of such employees.

2. Includible Compensation

The 1986 TRA added Code §414(s) which defines "compensation" for purposes of the nondiscrimination rules, including the actual deferral percentage limits for qualified cash or deferred arrangements for employee and employer matching contributions. Except as otherwise provided, compensation means the total compensation includible in an employee's gross income.[28] Moreover, an employer may elect to treat as compensation salary reduction amounts which are contributed by an employer under a cash or deferred arrangement, a tax-sheltered annuity program, a SEP or a cafeteria plan agreement and, therefore, are not includible in an employee's gross income.[29] If the employer so elects, it must apply such treatment on a consistent basis.[30] This requires that, if an employer treats elective contributions as compensation under one cash or deferred arrangement, it must do so for all such arrangements.[31] The compensation of self employed individuals will be determined under regulations reflecting the principles of the general rule.[32]

Section 414(s)(4) directs the Secretary to promulgate regulations prescribing alternative definitions of compensation which may be used by an employer. The Conference

[10] Act §1114(a) adding §414(q)(2).
[11] Act §1114(a) adding §414(q)(5)(A); H.R. Rep. 841, 99th Cong., 2d Sess., p. II-446 (1986), ("Conference Report").
[12] Act §1114(a) adding §414(q)(5)(B); Conf. Rep., p. II-446.
[13] Conf. Rep., p. II-446.
[14] Conf. Rep., p. II-446.
[15] Act §1114(a) adding §414(q)(4).
[16] Act §1114(a) adding §414(q)(8); Conf. Rep., p. II-447.
[17] Act §1114(a) adding §414(q)(6).
[18] Conf. Rep., p. II-447.
[19] Act §1114(a) adding §414(q)(6)(B).
[20] Act §1114(a) adding §414(q)(9); Conf. Rep., p. II-447.
[21] Conf. Rep., p. II-447; Senate Rep., p. 557.
[22] Act §1114(a) adding §414(q)(7); Conf. Rep., p. II-448.
[23] Act §1114(c)(1).
[24] Conf. Rep., p. II-448.
[25] Act §1114(c)(2).
[26] Act §1114(c)(3).
[27] Act §1114(c)(4).
[28] Act §1115(a) adding §414(s)(1); Conf. Rep., p. II-416.
[29] Act §1115(a) adding §414(s)(3).
[30] Conf. Rep., p. II-416.
[31] *Id.*
[32] Act §1115(a) adding §414(s)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Report provides that such alternatives must include an employee's basic or regular compensation, *e.g.*, disregarding bonuses and overtime.[33] Such an alternative definition, however, may be used only if its use would not discriminate in favor of highly compensated employees. Whether discrimination results is to be determined in objective manner based on the total includible compensation of employees.[34]

The §414(s) definition of compensation applies to years beginning after December 31, 1986.[35]

3. Coverage Tests

A qualified retirement plan must satisfy one of three alternative coverage tests:

(a) a percentage test under §410(b)(1)(A);

(b) a ratio test under §410(b)(1)(B); or

(c) an average benefits test under §410(b)(22).[36]

If an employer has no highly compensated employees, the plan automatically satisfies the coverage rules.[37]

a. Percentage Test

A plan satisfies the percentage test if it benefits at least 70% of all nonhighly compensated employees.[38] Employees who are plan participants are deemed to benefit under the plan and, thus, are considered in applying the percentage test. In the case of a qualified cash or deferred arrangement (or that portion of a defined benefit plan to which employee contributions or matching employer contributions are made), an employee eligible to make contributions to the plan is considered to benefit under the plan.[39]

b. Ratio Test

The ratio test is satisfied if the plan benefits a classification of employees set up by the employer which does not allow more than a reasonable difference between the coverage percentage of highly compensated employees and the coverage percentage of other employees.[40] The coverage percentage of highly compensated employees is the ratio of highly compensated employees who benefit under the plan to all such employees. The coverage percentage of other employees is the ratio of nonhighly compensated employees who benefit under the plan to all such employees. The ratio test is met if the coverage percentage of nonhighly compensated employees equals at least 70% of the coverage percentage of highly compensated employees.

Comment: Thus, for instance, a plan which benefits 100% of an employer's highly compensated employees must also benefit at least 70% of the employer's nonhighly compensated employees to satisfy the ratio test.

c. Average Benefits Test

A plan that satisfies the "reasonable classification" test of prior law (but not the post-TRA ratio test) will satisfy the average benefits test if the "average benefit percentage" for nonhighly compensated employees is at least 70% of the average benefit percentage for highly compensated employees.[41] The reasonable classification test of prior law will be applied as it is later modified judicially and administratively.[42] The test, however, is to be applied using the revised definitions of highly compensated employees and excludable employees, not the prior law definition of the prohibited group.[43] The test is to be applied on the basis of all the facts and circumstances.[44] Salient facts include the difference between the coverage percentages of the highly and non-highly compensated employees and the difference between the compensation of covered and excluded employees.[45] The Secretary is expected to promulgate regulations providing an objective safe harbor considering these and other relevant factors to facilitate compliance with the classification test.[46]

If the reasonable classification test is met, the plan must then satisfy the average benefit percentage requirement. Section 410(b)(2)(B) defines the average benefit percentage for a group of employees as the average of each employee's separate benefit percentage. "Benefit percentage" means the employer-provided contribution or benefit under all qualified plans, expressed as a percentage of the employee's compensation.[47] Employer-provided contributions include elective deferrals and forfeitures.[48] The Conference Report provides that, if benefit percentages are determined on the basis of employer-provided contributions, all such benefits are to be converted into contributions for testing purposes.[49] Likewise, if benefit percentages are determined on the basis of employer-provided benefits, contributions must be converted into benefits.[50]

The Conference Report provides that, in determining the amount of contributions or benefits, the approach taken by Rev. Rul. 81-202,[51] as modified by the Conference Report, controls.[52] Rev. Rul. 81-202 provides guidelines for determining whether several plans, considered as a single plan, provide discriminatory contributions and benefits. The ruling provides methods to adjust all types of benefits to a single form, methods to convert benefits into contributions and contributions into benefits, and methods for imputing the value for employer-provided Social Security benefits. For instance, utilization of the Rev. Rul. 81-202 approach means that, in the case of benefits testing, the benefit percentages are determined based on projected benefits.[53] The approach of Rev. Rul. 81-202 also controls in determining whether two plans which are treated as a

[33] Conf. Rep., p. II-416.
[34] *Id.*
[35] Act §1115(b).
[36] Act §1112(a).
[37] Conf. Rep., p. II-413
[38] Act §1112(a) amending §410(b)(1)(A); Conf. Rep., p. II-413.
[39] Act §1112 adding §401(a)(26)(C), §410(b)(6)(E).
[40] Act §1112(a) amending §410(b)(1)(B); Conf. Rep., p. II-413.
[41] Act §1112(a) amending §410(b)(2)(A).
[42] Conf. Rep., p. II-413.
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] Act §1112(a) amending §410(b)(2)(C)(i).
[48] Act §1112(a) amending §410(b)(2)(C)(i); Act §1115(b) adding §414(s); Conf. Rep., p. II-413.
[49] Conf. Rep., p. II-413.
[50] *Id.*
[51] 1981-2 C.B. 93.
[52] Conf. Rep., p. II-413.
[53] Conf. Rep., p. II-413.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

single plan for purposes of the coverage tests discriminate in favor of highly compensated employees.[54]

The Rev. Rul. 81-202 guidelines, however, are to be modified in several respects regarding the average benefits test and in order to determine whether two or more plans treated as a single plan under the percentage ratio or classification tests discriminate in favor of highly compensated employees.[55] First, the post-1986 TRA integration limits must be followed. Second, the post-TRA §414(s) definition of compensation, and the §401(a)(17) $200,000 limit on includible compensation apply.[56] Third, determinations under Rev. Rul. 81-202 must consider the rate at which benefits actually accrue. Moreover, when appropriate, the existence of different plan options, *e.g.*, loans or lump-sum distributions, that are available to a disproportionate number of highly compensated participants should also be considered.[57] These enumerated considerations, however, are not exhaustive.

The Conference Report also clarifies that, under Rev. Rul. 81-202, the same actuarial assumptions are to be used in valuing different benefits or contributions.[58] Moreover, in "appropriate circumstances" (the parameters of which are not addressed by the legislative history), Rev. Rul. 81-202 may be modified to consider reasonable salary projections. In circumstances justifying special scrutiny, the Secretary may require a certificate of comparability from an enrolled actuary.[59] As under prior law, the plan's vesting schedule also must be considered as provided by Rev. Rul. 74-165 [60] and Rev. Rul. 74-166.[61]

Note: It is not intended that the application of Rev. Rul. 81-202 to the average benefits percentage test be interpreted as requiring that an averaging approach be adopted for purposes of applying these rules to multiple plans being tested as a single plan under §401(a)(4).[62]

In determining benefit percentages, all pre-tax contributions or benefits are considered employer-provided, including elective contributions under a qualified cash or deferred arrangement.[63] Moreover, no qualified plan (including those which, standing alone, satisfy the percentage or ratio tests) may be disregarded in determining benefit percentages.[64] Contributions or benefits under other types of plans or programs (such as single employer plans or tax sheltered annuity programs), however, are disregarded.[65]

Once each employee's benefit percentage is determined, the average benefit percentage of highly and nonhighly compensated employees must be determined by averaging the individual benefit percentages of each employee, including those employees *not* covered by a plan.[66] Individual benefit percentages are to be computed in a similar manner as the actual deferral percentage of a group of employees under a qualified cash or deferred arrangement.[67]

In determining whether a plan satisfies the average benefits test, the employer may elect the period for which contributions and benefits are calculated.[68] An employer may calculate contributions or benefits either on an annual basis [69] or on the basis of a consecutive plan year period (not in excess of three years) ending with the current year.[70] The period of plan years chosen must be uniformly applied regarding all employees and cannot be changed without the consent of the Secretary.[71]

d. Aggregation and Comparability

In applying the percentage, ratio and average benefits tests, employees of corporations that are members of the same controlled group or all employees of a trade or business under common control are aggregated and treated as if employed by a single employer.[72] Likewise, employees of employers that are members of an affiliated group are treated as employed by a single employer.[73] The comparability analysis (regarding benefits and contributions) contained in Rev. Rul. 81-202 is to be modified as discussed, *supra*.[74]

e. Excludable Employees

In applying the percentage, ratio and classification tests, certain employees may be excluded. An employer may exclude:

(1) employees included in a unit covered by a collective bargaining agreement if there was evidence that retirement benefits were the subject of good faith bargaining;[75]

(2) in the case of a trust established or maintained pursuant to a collective bargaining agreement between airline pilots that must be represented in accordance with Title II of the Railway Labor Act and one or more employers, employees not covered by the collective bargaining agreement;[76]

(3) employees who are non-resident aliens receiving no earned income from sources within the United States;[77] and

(4) employees not meeting the age and service requirements prescribed by the plan.[78]

An employer may elect to separately test employees not meeting the §410(a)(1)(A) age 21 and service requirements.[79] Moreover, an employer may separately test one group of excludable employees without testing all excludable employees separately if the group is defined in a nondiscriminatory manner.[80] For example, an employer

[54] *Id.*
[55] Conf. Rep., pp. II-413-14.
[56] Conf. Rep., p. II-414.
[57] *Id.*
[58] Conf. Rep., p. II-414.
[59] *Id.*
[60] 1974-1 C.B. 96.
[61] 1974-1 C.B. 97.
[62] Conf. Rep., p. II-414.
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] Act §1112(a) amending §410(b)(2)(C)(ii); Conf. Rep., pp. II-414-15.
[69] Act §1112(a) amending §410(b)(2)(C)(ii)(I).
[70] Act §1112(a) amending §410(b)(2)(C)(ii)(I).
[71] Conf. Rep., pp. II-414-15.
[72] Act §1112(a) amending §410(b)(6)(B); Conf. Rep., p. II-415.
[73] *Id.*
[74] Conf. Rep., p. II-415.
[75] Act §1112(a) amending §410(b)(3)(A).
[76] Act §1112(a) amending §410(b)(3)(B).
[77] Act §1112(a) amending §410(b)(3)(C).
[78] Act §1112(a) amending §410(b)(4).
[79] Act §1112(a) amending §410(b)(4)(B).
[80] Conf. Rep., p. II-415.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

could separately test employees excludable because they do not meet the age requirements, but not include in this separate testing employees excluded under the one year of service rule.[81] Moreover, an employer can also elect to separately test all employees excludable solely on the grounds that they are not age 21, but who are at least 18.[82]

f. Special Rules for Dispositions or Acquisitions

If a person becomes, or ceases to be, a member of a controlled or affiliated service group within the meaning of §§414(b), (c), (m) or (o)), the minimum coverage requirements are deemed satisfied during the transition period if

(1) the coverage rules were satisfied immediately before the acquisition or disposition, and

(2) the coverage under the plan does not change significantly during the transition period (other than due to the disposition or acquisition).[83]

The transition period begins on the date of the disposition or acquisition and ends on the last day of the first plan year beginning after the transaction.[84]

g. Former Employees

The coverage rules may be applied separately to former employees.[85] For this purpose, rules similar to those applicable to statutory employee benefit plans will apply.[86] The legislative history suggests that the class of former employees to be tested may be restricted to those employees who have separated from service due to disability or who have retired on or after a reasonable retirement age.[87] Employers may further limit the class to employees who have retired within a specific time.[88] Reasonable assumptions regarding mortality also may be made so that the employer need not determine if former employees are still alive.[89]

h. Line of Business Exception

If the employer establishes to the satisfaction of the Secretary that it operates separate lines of business or operating units for *bona fide* business purposes, the percentage, ratio and average benefits tests may be applied separately to employees in each line of business.[90] The plan must be available, however, to a group of employees which qualify under a classification set up by the employer and found by the Secretary not to discriminate in favor of highly compensated employees.[91]

To be considered a separate line of business, §414(r)(2) requires that three threshold conditions be met:

(1) the line of business must have at least 50 employees who are non-excludable under §414(q)(8);

(2) the employer must notify the Secretary of its separate treatment; and

(3) the line of business must meet guidelines to be prescribed by regulations or the employer must receive a determination from the Secretary that the line of business may be treated as separate.

More than one line of business or operating unit may be aggregated to satisfy the 50 employee requirement.[92]

Section 414(r)(3) provides a safe harbor for a line of business if "the highly compensated employee percentage" respecting the line of business is not less than one half, nor more than twice, the percentage which highly compensated employees constitute of all employees. An employer is deemed to meet the 50% requirement if at least 10% of all highly compensated employees perform services solely for such line of business.[93] For purposes of the safe harbor, "highly compensated employee percentage" means the percentage which highly compensated employees performing services for the line of business constitute of all employees performing services for the line of business.[94]

Whether a separate line of business exists depends on the facts and circumstances.[95] In making such a determination, differences between services provided and product produced by claimed separate lines are to be considered.[96] The employer's method of business organization also is relevant.[97]

The line of business rule, however, may not be used to circumvent the nondiscrimination tests.[98] Thus, certain job classifications, *e.g.*, hourly or leased employees, are not considered separate line of business.[99] Moreover, secretaries and other support staff personnel would not comprise a separate line of business from an employer's professional staff.[100] Further, members of an affiliated service group (within the meaning of §414(m)) may not be treated as separate lines.[101] In addition, an operating unit must operate in "a significantly separate geographic area from another operating unit in the same line of business." [102] Two plants in the same city, thus, could not be separate operating units.[103]

The Secretary is directed to promulgate regulations delineating the treatment of employees of a headquarters or home office.[104] The Conference Report clarifies that such employees are to be allocated to one line of business or an operating unit.[105] Such allocation, generally, will be in accordance with the performance of services.[106] Therefore, if the majority of an employee's services are performed for one line of business, the employee must be allocated to that line of business.[107]

[81] *Id.*
[82] *Id.*
[83] Act §1112(a) amending §410(b)(6)(C); Senate Rep., p. 585.
[84] *Id.*
[85] Conf. Rep., p. II-416.
[86] *Id.*
[87] House Rep., p. II-534.
[88] Conf. Rep., p. II-534.
[89] *Id.*
[90] Act §1112(a) amending §410(b)(5); Conf. Rep., p. II-416.
[91] Act §1112(a) amending §410(b)(5)(B).
[92] Conf. Rep., p. II-524.
[93] Act §1115(a) adding §414(r)(3).
[94] Act §1115(a) adding §414(r)(4).
[95] Conf. Rep., p. II-523.
[96] Conf. Rep., pp. II-523-524.
[97] Conf. Rep., p. II-524.
[98] *Id.*
[99] Conf. Rep., p. II-522.
[100] *Id.*
[101] *Id.*
[102] Conf. Rep., p. II-524.
[103] *Id.*
[104] Act §1115(a) adding §414(r).
[105] Conf. Rep., p. II-524.
[106] *Id.*
[107] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Services provided by other employees to multiple lines of business are also to be allocated. The Conference Report provides that such an allocation is to be made in one of two ways.[108] First, employees may be allocated among lines of business on a pro rata basis in accordance with regulations to be prescribed.[109] Second, an employee may be allocated to any one line of business for which he performs substantial services, provided the allocation does not violate the highly compensated percentage rule described in the safe harbor.[110] Thus, if a line of business fails the 50% rule, highly compensated employees at headquarters who do not perform a majority of their services for a particular line of business must be allocated first to the failing line of business.[111] No highly compensated employee, however, may be allocated to a line of business if the allocation causes a violation of the 200% rule (regardless of whether a violation existed prior to the allocation).[112]

The Conference Report also provides that the Secretary should prescribe annual reporting rules for employers using the separate line of business rule.[113] The employer must include the basis for invoking the use of the rule. Moreover, if the employer has a separate line of business not failing within the safe harbor rule, that fact must be reported.[114]

The Conference Report also directs the Secretary to establish guidelines outlining circumstances in which there is to be special scrutiny of lines of business.[115] In illustrating such a case, the Conference Report states that, if a plan maintained for a separate line of business is significantly better or worse than that maintained for another line of business, special scrutiny is required.[116] Another instance where special scrutiny is demanded is where a disproportionate percentage of the accrued benefits under the plan of the separate line of business are for highly compensated employees.[117]

If a line of business does not satisfy the safe harbor rule *and* a plan of such business demands special scrutiny, the employer must obtain a determination from the Secretary that the line of business is separately operated for *bona fide* business purposes. Moreover, if an employer uses the separate line of business rule, all of its employees must be considered part of a line of business.[118] For instance, if an employer has 50 employees and 10 other employees not part of any line of business who would be separately tested, the 10 employees will be treated as part of some line of business. A line of business with only 10 employees, however, would need to be aggregated with another line in order to meet the 50 employee requirement.[119]

The Act also requires that benefits which are attributable to services for a line of business will be considered as provided by that line of business.[120] For purposes of the benefit rule, an employee performing services for more than one line of business who is allocated to one line of business is considered to provide services only for that line of business to which he is allocated.[121]

i. Special ESOP Rule

A trust that is part of a tax credit employee stock ownership plan, which is intended to be the only employer qualified plan, will not be treated as nonqualified solely because it fails to meet the coverage requirements so long as:

(1) the plan benefits 50% or more of all the employees who are eligible under a nondiscriminatory classification under the plan, and

(2) the sum of the amounts allocated to each participant's account for the year does not exceed 2% of the compensation of that participant for the year.[122]

j. Sanctions

If a plan fails to satisfy the minimum coverage rules, highly compensated employees, as defined by §414(q), are taxed on the value of their vested accrued benefit which is attributable to employer contributions and income on any contributions to the extent that such amounts have not been previously taxed to the employee.[123] If, however, the plan fails to meet the coverage requirements for more than one taxable year, any part of the vested accrued benefit will be taxed only once.[124] Nonhighly compensated employees are not taxable if the plan fails to satisfy the coverage standards.[125] This constitutes a radical departure from ERISA's prior provisions, under which the only sanction for failure to satisfy a qualification requirement, such as the minimum coverage rules, was plan disqualification.

k. Effective Dates

The amendments made to the minimum coverage rules generally are effective for plan years beginning after December 31, 1988.[126] The effective date for plans maintained pursuant to a collective bargaining agreement ratified before March 1, 1986 is the first plan year beginning *before* the earlier of;

(1) the later of

(a) January 1, 1989, or

(b) the date on which the last of the collective bargaining agreements terminates, determined without regard to any extension of such agreements made after February 28, 1986, or

(2) January 1, 1991.[127]

---

[108] *Id.*
[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] Conf. Rep., p. II-525.
[114] *Id.*
[115] *Id.*
[116] *Id.*
[117] *Id.*
[118] *Id.*
[119] *Id.*

[120] Act §1115(a) adding §414(r)(5); Conf. Rep., p. II-525. This benefit rule was substituted for the rule providing that if employees from more than one line of business are eligible to participate in a plan, all of those lines of business would be treated as one.
[121] Conf. Rep., pp. II-525-26.
[122] Act §1112(a) amending §410(b)(6)(D).
[123] Act §1112(c) adding §402(b)(2); Conf. Rep., pp. II-416-17.
[124] Act §1112(c) adding §402(b)(C).
[125] Act §1112(c) adding §402(b)(2)(A); Conf. Rep., pp. II-416-417.
[126] Act §1112(e)(1).
[127] Act §1112(e)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The addition of the separate line of business requirement is effective for years beginning after December 31, 1986.[128]

4. Minimum Participation Requirement

Code §401(a)(26), as added by the 1986 TRA, provides that a plan, to be qualified, must benefit, on each day of the plan year, the lesser of (1) 50 employees or (2) 40% of all employees.[129] If a plan fails to meet the minimum participation requirement, the entire plan fails to meet the §401(a) qualification standard and, therefore, is rendered taxable.[130]

In satisfying the minimum participation requirement, each plan maintained by an employer stands alone, *i.e.*, aggregation of comparable plans is not permitted.[131] In the case of contributions under §401(k) or §401(m), employees eligible to contribute under such plans will be considered as benefiting under the plan.[132] The minimum participation rule generally does not apply to a multi-employer plan, unless such plan covers professional employees, such as doctors, lawyers and investment bankers.[133]

a. Separate Benefit Structures

Section 401(a)(26)(F) grants the Secretary authority to promulgate regulations treating a separate benefit, separate trust or any other separate arrangement as a separate plan for purposes of the minimum participation rules.[134] A plan with two different formulae for calculating participants' benefits or contributions, thus, will be treated as two separate plans.[135] Moreover, if defined benefit plan assets are payable from more than one source, *e.g.*, more than one trust, each source may be considered a separate plan.[136] Further, if a particular person has priority regarding a source of assets for defined benefits, *e.g.*, a right to all or part of a possible reversion, such a person will be considered the sole participant of that "plan."[137]

In essence, Congress intended to define "plan" in the manner which would best advance the purposes of the minimum participation rules.[138] Therefore, if, under the facts and circumstances, an arrangement effectively provides a plan or account to a group of employees that would not meet the minimum participation requirements, more than one plan may be found.[139] In illustrating such a case, the Conference Report offers the example of a group of employees who agree to provide each employee with investment authority with respect to a separate pool of assets in a defined benefit structure.[140] In that case, if the employees are compensated for investment results that are obtained, each part of the asset pool may be considered a separate plan with respect to participant who controls its investment.[141] Moreover, combination defined benefit - defined contribution plans with benefit offset arrangements cannot be used to avoid the minimum participation requirements.[142]

b. Excludable Employees

Section 401(a)(26)(B) provides that certain employees may be excluded in determining whether the 40% requirement is satisfied. All employees excludable under §§401(b)(3) and (4)(A) of the minimum coverage rules, discussed *supra*, may be excluded. In addition, employees who have not attained age 21 or completed one year of service may be excluded if this group of employees, tested separately, satisfies the minimum participation requirements.[143] Benefits for these excluded employees, however, must be provided under the same plan as for other employees.[144] Moreover, benefits to these excluded employees may not be greater than comparable benefits provided to other non-excludable employees under the plan.[145] Further, no highly compensated employees, as defined under §414(q), may be included in the group of excluded employees for more than one year.[146] Thus, if a highly compensated employee is part of this group for more than one year, all employees must be considered in applying the 40% rule.[147] Except to the extent provided in regulations, §401(a)(26) does not apply to a plan covering only employees who are in a multiemployer plan within the meaning of §414(f) and who are covered by a collective bargaining agreement.[148] Further, under §401(a)(26)(D), except to the extent provided in regulations, a plan covering only employees described in §410(b)(3)(A) (*i.e.*, covered by a collective bargaining agreement where retirement benefits have been the subject of good faith collective bargaining) may exclude from consideration any employee who is not included in the unit or units in which the covered employees are included.

If any excludable employee is covered by a defined benefit plan, all employees will be taken into account in applying the minimum participation rule unless:

(1) the benefits provided under such coverage are comparable (or less than comparable) to the coverage of nonexcludable employees; and

(2) the plan covering the excludable employees would satisfy the minimum participation requirement (considering all employees) but for the fact that the plan has a different defined benefit structure from the plan covering nonexcludable employees.[149]

Therefore, defined benefit payments to nonexcludable and excludable employees must come from the same source.[150] Moreover, if only excludable employees are covered by the

[128] Act §1115(b).
[129] Act §1112(b) adding §401(a)(26)(A).
[130] Conf. Rep., p. II-423.
[131] Conf. Rep., pp. II-422-23; Senate Rep., p. II-588.
[132] Act §1112(b) adding §401(a)(26)(C).
[133] Conf. Rep., p. II-422. No inference is to be made, however, that a plan which covers a professional is a multi-employer plan.
[134] Conf. Rep., p. II-422. Note that the Conf. Rep. uses the phrase "any separate arrangement with respect to a defined benefit plan," while the statute uses the phrase "any separate arrangement."
[135] *Id.*
[136] *Id.*
[137] *Id.*
[138] *Id.*
[139] *Id.*
[140] *Id.*
[141] Conf. Rep., pp. II-422-23.
[142] Conf. Rep., p. II-423.
[143] Act §1112(b) adding §410(a)(26)(B)(ii).
[144] Act §1112(b) adding §410(a)(26)(B)(ii)(I).
[145] Act §1112(b) adding §410(a)(26)(B)(ii)(II).
[146] Act §1112(b) adding §410(a)(26)(B)(ii)(III); Conf. Rep., p. II-423.
[147] Conf. Rep., p. II-423.
[148] Act §1112(b) adding §401(a)(26)(E).
[149] Conf. Rep., p. II-423.
[150] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

defined benefit plan, all employees will be considered in determining whether the minimum participation requirements are met.[151]

c. Exemptions from the Minimum Participation Rules

The Conference Report authorizes the Secretary to exempt certain plans from the application of the minimum participation rules. First, the Secretary may exempt a plan benefiting no employee who is, or has ever been, a highly compensated employee with respect to service being credited under the plan, provided that the plan is not necessary to another plan or plans to satisfy the applicable §410(b) coverage rules, discussed *supra*.[152] Second, a plan that may not be terminated due to the provisions of the Single Employer Pension Plan Amendment Act (SEPPAA) because it is unfunded may be exempted by the Secretary.[153] For a nonterminable SEPPAA plan to be exempt it must:

(1) cease benefit accruals;

(2) obtain a letter of insufficiency for each plan year of exemption; and

(3) eliminate, in accordance with regulations, any different benefit structure or separate arrangement [154]

d. Exemption from Reversion Tax

Section 4980 imposes an excise tax on the reversion of plan assets to the employer upon the termination of a plan. The excise tax will not apply, however, if:

(1) the plan was in existence on August 16, 1986;

(2) the plan would fail to meet the minimum participation requirements if they were in effect on August 16, 1986; and

(3) there is no transfer of plan assets or liabilities or merger or spinoff after August 16, 1986.[155]

A termination and reversion are possible even if the plan relies on another plan, which was terminated, for its qualification.[156] In determining the amount of the reversion, the present value of a highly compensated employee's accrued benefits is determined by using an interest rate which equals the maximum interest rate that may be used for calculating accrued benefits under §411(a)(11)(B).[157] The Secretary is directed to issue regulations preventing avoidance of the interest rate provision through distributions prior to or in lieu of a reversion.[158]

e. Effective Date

The revised minimum participation rules are generally effective for plan years beginning after December 31, 1988.[159] The effective date applicable to plans maintained pursuant to a collective bargaining agreement ratified before March 1, 1986 is the first plan year beginning *before* the earlier of

(1) the later of —

(a) January 1, 1989 or

(b) the date on which the last of the collective bargaining agreements terminates, as determined without regard to any extension of such agreements made after February 28, 1986, or

(2) January 1, 1991.[160]

5. Minimum Vesting Requirements

a. Vesting Schedules

The 1986 TRA repealed class year vesting.[161] The Act also replaced the pre-1986 TRA regular §411 minimum vesting schedules with two alternative vesting schedules.[162] As amended, §411(a)(2)(A) provides a five-year cliff vesting schedule which requires that a participant's right to employer-derived benefits be non-forfeitable after the end of five years of service. Alternatively, §411(a((2)(B) permits seven-year graded vesting according to the following schedule:

Years of Service	*Percentage Vested*
less than 3	0%
3	20%
4	40%
5	60%
6	80%
7	100%

Benefits under collectively bargained multi-employer plans with respect to employees covered by a collective bargaining agreement may vest under the 10-year cliff vesting schedule of pre-TRA law, provided that employees covered by such plans who are not part of the bargaining unit vest under either five- year cliff, or seven-year graded vesting.[163]

Note: Benefits which vest due to these rules are immediately guaranteed by the Pension Benefit Guaranty Corporation.[164]

Notwithstanding the above amendments to the §411(a) regular vesting schedule, the accelerated vesting rules of §416 continue to apply (unrevised) to top heavy plans.[165]

A special 100% vesting rule applies to certain plans. As a condition of participation, a plan may require the completion of two years of service, rather than one year of service.[166] If the plan requires more than one year of participation, the plan must provide complete and immediate vesting of each participant's benefits as it accrues.[167]

[151] *Id.*
[152] *Id.*
[153] Conf. Rep., p. II-523.
[154] *Id.*
[155] Act §1112(e)(3); Conf. Rep., p. II-423.
[156] *Id.*
[157] Act §1112(e)(3)(B); Conf. Rep., p. II-424.
[158] Conf. Rep., p. II-424.
[159] Act §1112(e)(1).
[160] Act §1112(e)(2).
[161] Act §1113(b) repealing §411(d).
[162] Act §1113(a) amending §411(a).
[163] Act §1113(a) amending §411(a)(2)(C).
[164] Conf. Rep., p. II-427.
[165] Conf. Rep., p. II-426.
[166] Act §1113(c) amending §410(a)(1)(B); Conf. Rep., pp. II-426-27.
[167] Act §1113(c) amending §410(a)(1)(B); Conf. Rep., p. II-427.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Under pre-TRA law, plans that provided immediate vesting could delay participation for up to three years.

Note: Qualified cash or deferred arrangements (and plans including CODAs) may not require the completion of more than one year of service as a precondition to participation.

Comment: Since years of service are determined under the usual §411 rules, pre-1989 years are taken into account.

If a plan amendment changes the vesting schedule, each participant with three years of service is given the right to elect to have the non-forfeitable percentage of his accrued benefit computed without regard to the amendment. Prior to the TRA, this right was only extended to participants with five years of service at the time of the amendment.[168] The Act also made conforming amendments to ERISA which reflect the revised vesting provisions.[169]

b. Effective Date

The 1986 TRA vesting rules generally are effective for participants with one hour of service in plan years beginning after December 31, 1988.[170] In the case of a collectively bargained plan which was ratified before March 1, 1986, the vesting rules are not effective until the earlier of:

(1) the later of —

(a) January 1, 1989 or

(b) the date on which last collective bargaining agreement terminates (determined without regard to any extensions after February 28, 1986), or

(2) January 1, 1991.[171]

6. Integrated Plans

a. Defined Contribution Plans

The 1986 TRA amended the rules applicable to the nondiscriminatory coordination of defined contribution plans with OASDI, *i.e.*, Social Security, by limiting the permitted disparity in plan contributions. The Act accomplishes this by limiting the extent to which the "excess contribution percentage" for a defined contribution plan may exceed the "base contribution percentage." [172] The "excess contribution percentage" for a plan is the percentage of compensation which is contributed under the plan with respect to the portion of each participant's compensation in excess of the plan's integration level.[173] The "base contribution percentage" is the percentage of compensation which is contributed under the plan with respect to the portion of each participant's that is not in excess of the specified integration level.[174] The plan's integration level is the amount of compensation specified under the plan at (or below) which the rate at which contributions are provided (expressed as a percentage) is less than the rate of contribution provided above that amount of compensation.[175] The relevant amount of compensation may be specified by either a dollar amount or a formula.[176] In no event, however, may the integration level exceed the OASDI contribution base (*i.e.*, the taxable wage base) in effect at the beginning of the plan year.[177] The Secretary may promulgate regulations "to prevent an employer from selecting a lower integration level that discriminates in favor of highly compensated employees.[178] A uniform integration level must be applied to all participants.[179]

Note: As discussed, *supra*, §414(s) defines compensation as all compensation includible in gross income. Compensation which exceeds the §401(a)(17) $200,000 limit (subject to cost-of-living adjustments), however, is not included in determining the contribution percentages.

A defined contribution plan satisfies the 1986 TRA permitted disparity limits if the excess contribution percentage does not exceed the *lesser* of:

(1) the base contribution percentage, or

(2) the greater of —

(a) 5.7 percentage points, or

(b) the old age insurance tax rate [180] in effect at the beginning of the plan year.[181]

Note: For 1986 the rate of tax attributable to old-age insurance is less than 5%. The Social Security Administration is to advise the Secretary when the rate exceeds 5.7% so that timely publication of the new rate can be made.[182]

Note: Contributions subject to the nondiscrimination rules applicable to cash or deferred arrangements, matching contributions and SEPs cannot rely on integration to satisfy the nondiscrimination rules.[183]

b. Defined Benefit Excess Plans

(1) General

To satisfy the permitted disparity limits, three requirements must be met.[184] First, the excess benefit percentage may not exceed the base benefit percentage by more than the maximum excess allowance.[185] Second, any optional form of benefit, preretirement benefit, and actuarial feature (and any other factor or feature under the plan) provided with respect to compensation in excess of the integration level must also be provided with respect to compensation not in excess of such level.[186] Third, benefits are to be based on average annual compensation.[187]

[168] Act §1113(d)(B) amending §411(a)(10); Conf. Rep., p. II-426.
[169] Act §1113(c).
[170] Act §1113(e)(1), (3); Conf. Rep., pp. II-426-27.
[171] Act §1113(e)(2); Conf. Rep., p. II-427.
[172] Act §1111(a) amending §401(l)(2)(B)(i).
[173] Act §1111(a) amending §401(l)(2)(B)(i); Conf. Rep., p. II-436.
[174] Act §1111(a) amending §401(l)(2)(B)(ii); Conf. Rep., p. II-436.
[175] Act §1111(a) amending §401(l)(5)(A).
[176] *Id.*
[177] Act §1111(a) amending §401(l)(5)(a)(ii); Conf. Rep., p. II-436. For years beginning in 1986, the taxable wage base is $42,000.
[178] Conf. Rep., p. II-436.
[179] Act §1111(a) amending §401(e)(5)(A)(iii).
[180] *See* §3111(a).
[181] Act §1111(a) amending §401(l)(2)(A); Conf. Rep., p. II-436.
[182] Conf. Rep., p. II-436.
[183] *Id.*
[184] Act §1111(a) amending §401(l)(3).
[185] Act §1111(a) amending §401(l)(3)(A)(i)(I).
[186] *Id.*
[187] *Id.*

(2) Excess Benefit Percentage

Section 401(l)(3) limits the extent to which the "excess benefit percentage" under defined benefit excess plans may exceed the "base benefit percentage." The excess benefit percentage is the value of benefits provided by the plan with respect to compensation in excess of the applicable integration level, expressed as a percentage of compensation.[188] The base benefit percentage is the value of benefits provided with respect to compensation not in excess of the applicable integration level, expressed as a percentage of compensation.[189] As with defined contribution plans, the applicable integration level may not exceed the social security wage base in effect at the beginning of the plan year.[190] Pursuant to regulations, however, excess plans may use two or more integration levels.[191] If multiple integration levels are utilized, each level's permitted disparity is based upon the percentages of compensation up to each level replaced by the employer-provided worker's benefit (PIA) under Social Security.[192]

Note: As in the case of defined contribution plans, the §414(s) definition of compensation applies, as does the §401(a)(17) $200,000 limit on includible compensation.

(3) Excess Allowance

Special rules define the maximum excess allowance by which the excess benefit percentage may exceed the base benefit percentage. Section 401(l)(4)(A) provides that, with respect to benefits attributable to any year of service taken into account under the plan, the maximum excess allowance is the lesser of: (1) ¾ of a percentage point or (2) the base benefit percentage. With respect to total benefits under the plan, the maximum excess allowance equals ¾ of a percentage point multiplied by the number of the participant's years of service (not in excess of 35) taken into account under the plan.[193]

A year is taken into account for purposes of determining the maximum excess allowance if benefits are treated as accruing on behalf of the participant in a given year.[194] Excess plans providing for the accrual of benefits over a participant's years in service, therefore, are treated as taking into account only years of participation.[195] The maximum excess allowance applies to both flat benefit final pay plans and unit benefit final pay plans.[196]

Section 401(l)(4)(C) directs the Secretary to promulgate regulations reducing the ¾% factor in cases where a plan uses integration levels in excess of covered compensation. As under prior law, "covered compensation" means the average of the contribution and benefit taxable wage bases (under Social Security) in effect for each year of the 35-year period ending with the year in which the employee attains age 65,[197] assuming there is no increase in the wage base for years after the determination year and before the employee attains age 65.[198] Reductions for higher integration levels are to be based on the decreasing percentages of compensation replaced by the employer-provided contributions under Social Security as compensation increases above covered compensation.[199] In addition, the Conference Report directs the Secretary to provide for such reductions on the basis of brackets of integration levels in excess of covered compensation. Such reductions and brackets should correspond to the comparable reductions and brackets for offset plans. The Secretary, however, is not authorized to provide for an increase in the ¾% factor for plans using integration levels lower than covered compensation.[200]

c. Defined Benefit Offset Plans

In the case of a defined offset plan, §401(l)(3)(B) provides that a participant's accrued benefit cannot be reduced due to the offset by more than the maximum offset allowance. In addition, benefits must be based on average annual compensation.[201]

In the case of benefits attributable to any year of service, the maximum offset allowance equals the lesser of

(1) ¾% of a participant's final average compensation, or

(2) 50% of the benefit which would have accrued without regard to the offset reduction.[202]

With respect to total benefits, the maximum offset allowance equals the lesser of:

(1) ¾% of a participant's final average compensation multiplied by the participant's years of service (not in excess of 35) taken into account under the plan, or

(2) 50% of the benefit which would have accrued without regard to the offset reduction.[203]

Final average compensation equals the lesser of

(1) the participant's average annual compensation for the three-consecutive year period ending with the current year, or

(2) the participant's full period of service.[204] Final average compensation, however, is calculated without regard to compensation in any year in excess of the taxable wage base for that year.[205]

Pursuant to regulations, the ¾ factor is reduced for participants with final average compensation in excess of covered compensation defined *supra*.[206] As in the case of excess plans, the reduction is based upon the decreasing percentages of compensation replaced by the employer-pro-

[188] Act §1111(a) amending §401(l)(3)(A)(ii); Conf. Rep., p. II-436.
[189] *Id.*
[190] *Id.*
[191] Act §1111(a) amending §401(1)(5)(A)(iv); Conf. Rep., p. II-438.
[192] Conf. Rep., p. II-538.
[193] Act §1111(a) amending §401(l)(4)(A)(ii).
[194] Conf. Rep., p. II-437.
[195] *Id.*
[196] Conf. Rep., p. II-437.
[197] Act §1111(a) amending §401(l)(5)(E)(i).
[198] Act §1111(a) amending §401(l)(5)(E)(ii).
[199] Act §1111(a) amending §401(l)(5)(C)(ii); Conf. Rep., p. II-438. In developing regulations governing the 3/4% factor reduction, the Secretary is directed to consult with the Social Security Administration.
[200] Conf. Rep., p. II-437.
[201] Act §1111(a) amending §401(l)(3)(B)(ii).
[202] Act §1111(a) amending §401(l)(4)(B)(i). The Conf. Rep.'s description of the offset allowance is in error. *See* p. II-438.
[203] Act §1111(a) amending §401(l)(4)(B)(ii).
[204] Act §1111(a) amending §401(l)(5)(D)(i).
[205] Act §1111(a) amending §401(l)(5)(D)(ii).
[206] Act §1111(a) amending §401(e)(4)(C)(i)(II); Conf. Rep., p. II-438.

vided contributions under Social Security as compensation increases above covered compensation.[207] These reductions for offset plans are to correspond to those for excess plans using integration levels in excess of covered compensation.[208] The Secretary is directed to publish an annual table which sets forth offset factors for brackets of final average compensation in excess of covered compensation.[209]

d. Multiple Integrated Plans

The Secretary is directed to develop regulations to prevent the excessive use of permitted disparities, with respect to any employee, through the integration of more than one qualified plan.[210] These rules must limit to 100% the sum of the percentages, calculated separately for each plan with overlapping coverage, of the maximum benefit disparity actually used in each plan.[211]

e. Effective Dates

The 1986 TRA amendments to the integration rules generally apply to benefits attributable to plan years beginning after December 31, 1988.[212] In the case of a plan maintained pursuant to a collective bargaining agreement ratified before March 1, 1986, these rules do *not* apply to benefits pursuant to, and individuals covered by, such agreement in plan years beginning before the earlier of

(1) the later of —

(a) January 1, 1989, or

(b) the date on which the last of such collective bargaining agreements terminates without regard to any extensions after February 28, 1986, or

(2) January 1, 1991.[213]

7. Nondiscrimination Rules

a. General

Pursuant to a 1986 TRA conforming amendment to §401(a)(5), a classification is not considered discriminatory within the meaning of §§401(a)(4) or 410(b)(2)(A)(i) merely because it is limited to salaried or clerical employees.[214] Moreover, a plan will not be considered discriminatory within the meaning of §401(a)(4) simply because contributions or benefits of, or on behalf of, employees under the plan bear a uniform relationship to the compensation, as defined by §414(s), of these employees.[215] Further, a plan is not to be considered discriminatory if it favors highly compensated employees in a manner permitted under §401(l).[216]

b. Integrated Defined Benefit Plans

The Act applies a special rule to both excess and offset defined benefit plans.[217] The rule is designed to prevent employers from claiming credit for another employer's Social Security contributions in integrating its plan. Under the rule, a plan shall not fail to qualify under §401(a) "merely because the plan provides that the employer-derived accrued retirement benefit for any participant under the plan may not exceed the excess (if any) of —

(I) the participant's final pay with the employers, over

(II) the employer-derived retirement benefit (PIA) under Social Security attributable to the participant's service with the employer.[218] The employer-derived benefit is treated as accruing ratably over 35 years.[219] Final pay is defined as the total compensation (within the meaning of §414(q)(7) paid to the participant by the employer for any year (i) which ends during the five-year period which ends with the year in which the participant separates from service and (ii) for which the participant's total compensation from the employer was the highest.[220]

c. Single Plan Treatment

In determining whether two or more plans satisfy the nondiscrimination requirements of §401(a)(4) when considered as a single plan, certain special rules apply.[221] First, if the amount of contributions on behalf of the employees allowed as a deduction under §404 under these plans when taken together, bears a uniform relationship to the compensation (within the meaning of §414(s)) of such employees, the plans are not considered discriminatory simply because the rights of the employees to the employer contributions do not become nonforfeitable at the same time under the plans. Second, if regulations to be promulgated are satisfied, plans will not be considered discriminatory merely because employees' rights to benefits under the plans become nonforfeitable at different rates.

d. Effective Dates

The above amendments made by §1111 of the 1986 TRA generally apply to benefits attributable to plan years beginning after December 31, 1988.[222] In the case of a plan maintained pursuant to a collective bargaining agreement ratified before March 1, 1986, these rules do *not* apply to benefits pursuant to, and individuals covered by, such agreement in plan years beginning before the earlier of:

(1) the later of —

(a) January 1, 1989, or

(b) the date on which the last of such collective bargaining agreements terminates without regard to any extensions after February 28, 1986, or

(2) January 1, 1991.[223]

II. Contribution and Benefit Limitations

A. Introduction

Annual additions to a participant's account in a qualified defined contribution plan and benefits accruable under

[207] Act §1111(a) amending §401(e)(4)(C)(ii); Conf. Rep., p. II-438.
[208] Conf. Rep., p. II-438.
[209] *Id.*
[210] Act §1111(a) amending §401(l)(5)(F); Conf. Rep., p. II-439.
[211] *Id.*
[212] Act §1111(c)(1).
[213] Act §1111(c)(3).
[214] Act §1111(b) amending §401(a)(5)(A).
[215] Act §1111(b) amending §401(a)(5)(B).
[216] Act §1111(b) amending §401(a)(5)(C).
[217] Act §1111(b).
[218] Act §1111(b) amending §401(a)(5)(D)(i); Conf. Rep., p. II-439.
[219] *Id.*
[220] Act §1111(b) amending §401(a)(5)(D)(ii).
[221] Act §1111(b) amending §401(a)(5)(E).
[222] Act §1111(c)(1).
[223] Act §1111(c)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

qualified defined benefit plans are subject to limits under Code §415. For defined contribution plans, the annual addition is limited to the lesser of 25% of compensation for the year, or $30,000. Under pre-1986 TRA law, the annual addition consisted of all employer contributions, a specified portion of employee contributions, and all reallocated forfeitures. This amount of employee contributions taken into account in computing a participant's annual addition was the lesser of one-half of the employee's nondeductible contributions or total nondeductible employee contributions in excess of 6% of compensation. Under pre-TRA law, the $30,000 limit was scheduled to be adjusted beginning in 1988 for post-1986 cost-of-living increases. The cost-of-living increases to the dollar limits were to be adjusted in the same manner as the adjustments to the primary insurance amounts under Social Security, which are generally adjusted by the percentage increases in the consumer price index.

The limit on annual benefits derived from employer contributions to a defined benefit pension plan is 100% of average compensation or $90,000, whichever is less. The $90,000 limit will be indexed beginning in 1988, to reflect post-1986 cost-of-living increases. Under pre-1986 TRA law, if retirement benefits commenced before age 62, the $90,000 limit was reduced so that it would be the actuarial equivalent of an annual benefit of $90,000 commencing at age 62. There was a floor on this reduction, however, prohibiting the dollar limit applicable to benefits commencing at or after age 55 from falling below $75,000. For benefits commencing before age 55, the $75,000 was reduced actuarially. Under pre-1986 TRA law, the reduction in the dollar limit for benefits commencing before age 62, and the reduction in the $75,000 amount for benefits commencing before age 55, had to be computed using an interest rate assumption not less than the greater of 5% or the rate specified in the plan for purposes of determining benefits payable before the normal retirement age.

Similarly, if retirement benefits under a defined benefit plan began after age 65, the $90,000 limit was increased to the actuarial equivalent of an annual benefit of $90,000 beginning at age 65. The increase was computed using an interest rate assumption not greater than the lesser of 5% or the rate specified in the plan. Pre-1986 TRA law did not require that a plan provide increased benefits for participants retiring after age 65.

Under pre-TRA law, where a participant had less than 10 years of *service*, the §415 limits were reduced by 10% per year for each year of service less than 10.

Under pre-TRA law, there were no special provisions for employees who are statutorily required to retire before age 55, such as certain police and firefighters, as well as commercial airline pilots. Also, under pre-1986 TRA law, there were no provisions permitting employers and participants to make contributions to a defined benefit plan to fund post-annuity starting date cost-of-living increases.

Under pre-1986 TRA law, provided the plan was not top-heavy, there was no limit to the amount of compensation that could be taken into account for purposes of computing the annual addition to a defined contribution plan or the annual benefit derived from the employer contributions under a defined benefit plan. If the plan was top-heavy, a $200,000 limit applied.

Plans that do not comply with the overall limits set forth in Code §415 are not qualified plans.

In enacting changes to the contribution and benefit limits, Congress was concerned that the dollar limits on benefits were more generous for individuals who retired before the Social Security retirement age (presently age 65) than the limits for individuals who retired on or after that age, because of the manner in which the dollar limits were actuarially reduced for early retirement. Congress believed that the rules encouraged early retirements.

In adjusting the dollar limits for qualified plans, Congress was concerned not only about the dollar amounts appropriate for the separate plan limits, but also about the relative attractiveness of defined contribution versus defined benefit plans and the appropriateness of the prior law adjustments for the cost-of-living. The 1986 TRA changes Act reflect the conclusion that defined benefit plans generally provide better overall retirement income security because participants in these plans are protected against bad investment experience and because many plans provide protection against inflation, at least up to normal retirement age, in that benefits are often based on final average pay. As a result, in setting the increases in the dollar limits on contributions and benefits under the two types of plans, Congress provided for a gradual change in the ratio between the defined benefit and defined contribution plan dollar limits.[224]

Congress was also concerned that the rule requiring reduced limits on benefits payable to participants with fewer than 10 years of service was not effectively limiting benefits for highly compensated employees with short periods of participation. The legislative history indicates Congress' awareness that some employers planned the timing of the establishment of a defined benefit plan (or an increase in benefits under a pre-existing plan) to coincide with projected retirement of one or more of the employer's highly compensated employees. As a result, some employers set up plans at a late date, rather than an earlier date, precluding other employees, such as rank and file employees, from accruing (and becoming vested in) greater benefits.[225]

B. Overview

The Tax Reform Act of 1986 made several adjustments to the annual contribution and benefit limits of Code §415. For defined contribution plans, while it did not change the $30,000 limit, it slowed down and changed the rate at which the dollar limitation increases to reflect changes in the cost-of-living.[226] In addition, the formula for computing the dollar limit must, after the TRA, include *all* after-tax contributions of a participant to any plan in which he or she participates.[227]

Under the revised provisions, the defined contribution plan dollar limit is tied to increases in the defined benefit dollar limit. The defined contribution plan dollar limit will not change until the defined benefit plan dollar limit

[224] House Rep., pp. 739-40; Senate Rep., pp. 622-23.
[225] Senate Rep., pp. 622-23; House Rep., pp. 739-41.
[226] Act §1106(a). Code §415(c)(1)(A).
[227] Act §1106(e). Code §415(c)(2)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

reaches $120,000 due to cost-of-living adjustments. Once the defined benefit plan limit reaches $120,000, the defined contribution dollar limit will increase so that it will always be 25% of the defined benefit dollar limit.[228] (Under prior law, the defined contribution limit was one-third the defined benefit limit.)

With regard to defined benefit plans, the $90,000 dollar limit will increase starting in 1988 to reflect post-1986 cost-of-living increases in accordance with the provisions of prior law.[229] The Act requires, however, that actuarial adjustments be made with regard to those participants retiring before the Social Security retirement age.[230] The Act removed the window period of pre-TRA law which retained the regular defined benefit plan dollar limit for individuals retiring between ages 62 and 65 and removed the $75,000 floor on actuarial reductions for participants retiring at or after age 55.[231]

Recognizing the special needs of certain categories of professionals such as police, firefighters and pilots who are often required to retire at an earlier age, more liberal actuarial reduction rules apply to these individuals.[232]

The Act introduces a defined benefit plan concept, whereby employers and employees may make after-tax contributions to defined benefit plans to provide for cost-of-living increases in benefits after the annuity starting date.[233]

The Act also places a cap on the amount of annual compensation that may be taken into account for purposes of plan qualification and nondiscrimination. The $200,000 limit previously applicable only to top-heavy plans and SEPs was applied to all qualified plans regardless of whether they are top-heavy.[234]

Note: A plan may incorporate by reference the revised Code §415 rules.[235]

The 1986 TRA modifications to the Code §415 limits apply generally to years beginning after December 31, 1986.[236] This effective date is modified in the case of plans maintained pursuant to collective bargaining agreements [237] and, contains protection for accrued benefits of participants in defined benefit plans in existence on May 6, 1986.[238] Further, where a plan satisfied the requirements of Code §415 for its last plan year beginning before January 1, 1987, the sum of the defined benefit plan fraction and the defined contribution plan fraction computed under Code §415(e)(1) will be deemed not to exceed 1.0 for that year.[239] There is a special effective date rule for the $200,000 limit on annual compensation. In general, that provision applies to benefits accruing in years beginning after December 31, 1988, except in the case of plans maintained pursuant to collective bargaining agreements which will have a later compliance date.[240] With regard to the inclusion of all employee contributions in the formula for determining the limit on annual additions to defined contribution plans, the application of the post-TRA rule does not require the recomputation of the additions for purposes of the combined plan fraction, for any year beginning before 1987.[241]

Note: Although plans do not have to be amended until the first plan year beginning after December 31, 1988, employers with defined benefit plans should amend plans to conform to the revised Code §415 limits as soon as possible. Failure to do so may result in participants accruing benefits in excess of the limits, possibly causing the funding of excess benefits on a nondeductible basis and the imposition of a 10% excise tax on nondeductible contributions.

C. Detailed Analysis

1. Defined Contribution Plans

a. Dollar Limitations

The §415 defined contribution plan dollar limit applicable to a limitation year is temporarily frozen at an amount equal to the greater of $30,000 or 25% of the defined benefit plan dollar limit for the limitation year. The dollar limit is scheduled to increase to reflect cost-of-living changes only when the defined benefit dollar limitation reaches $120,000. Thereafter, as the defined benefit contribution plan dollar limit increases to reflect changes in the cost of living, the defined contribution plan contribution limits will similarly rise, provided, however, that the defined contribution limit shall remain 25% of the defined benefit limit at all times.[242]

b. After-Tax Contributions

The Act provides that the definition of annual addition for purposes of computing the defined contribution plan limit will include 100% of all after-tax employee contributions, rather than the specified portion that was counted under pre-TRA law.[243] This denies participants the opportunity to contribute up to 6% of compensation without having to consider the contribution's impact on the §415 limits.

Note: The revised definition for annual additions to defined contribution plans does not require the recalculation of amounts added to the numerator of the defined contribution plan fraction with respect to any year beginning before January 1, 1987.[244]

The Act also liberalized the rules relating to employee contributions for retiree medical benefits. It provided an exclusion for contributions made by retired non-key employees for retiree medical coverage. Such amounts are not to be included in the percentage of compensation limit on annual additions.[245] Thus, for purposes of computing the

[228] Act §1106(a). Code §415(c)(1)(A).
[229] Code §415(d)(1) and (3).
[230] Act §1106(b)(1). Act §§415(b)(2)(C) and 415(b)(8).
[231] *Id.*
[232] Act §1106(b)(2) and (3). Code §415(b)(2)(F), (G) and (H) and §415(b)(9).
[233] Act §1106(c). Code §415(k)(2).
[234] Act §1106(d). Code §§401(a)(17) and 404(l).
[235] Act §1106(h).
[236] Act §1106(i).
[237] Act §1106(i)(2).
[238] Act §1106(i)(3).
[239] Act §1106(i)(4).
[240] Act §1106(i)(5).
[241] Act §1106(i)(6).
[242] Act §1106(1). Code §415(c)(1)(A).
[243] Act §1106(e). Code §415(c)(2)(B).
[244] Act §1106(i)(6).
[245] Act §1106(e)(2). Code §415(c)(2).

25% of compensation limit, contributions for retiree medical coverage are not included.

c. Technical Correction to Tax Reform Act of 1984

Section §1852(h)(2) of the Act expands the provisions of §528 of the Tax Reform Act of 1984 and Code §415(l)(1) to clarify that plan contributions used to provide medical benefits to retired employees, while being considered annual additions, will not be subject to the 25% of compensation limit generally applicable to defined contribution plans.

2. Defined Benefit Plans

a. Dollar Limitations

The Act does not change the maximum dollar limit on annual benefits payable from a defined benefit plan under prior law. That amount remains at $90,000 and is scheduled to be adjusted for post-1986 cost-of-living increases beginning in 1988. The adjustments will be made based on increases in the consumer price index.[246]

b. Actuarial Adjustments for Retirement Before Social Security Retirement Age

The Act increased the age at which the maximum dollar limit becomes payable from age 62 to the Social Security retirement age.[247]

"Social Security retirement age" is defined as the age used as the retirement age in the Social Security Act with some modifications.[248]

Note: The Social Security retirement age is currently 65, however, the age is scheduled to increase to age 67 by year 2017. In the future, the Social Security retirement age will depend on an individual's date of birth. For individuals born before January 1, 1938, the Social Security retirement age will be 65; for individuals born after December 31, 1937 and before January 1, 1955, the Social Security retirement age will be 66; and for individuals born after December 31, 1954, the Social Security retirement age will be 67.[249]

The limit on the annual benefit is actuarially reduced if the benefit commences before the Social Security retirement age to the actuarial equivalent of the limit applicable for benefits commencing at the Social Security retirement age.[250] Specifically, if benefits commence before the Social Security retirement age, the $90,000 dollar limit (but not the 100% limit) will be reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at Social Security retirement age. The Act also repealed the $75,000 floor for early retirement under which the dollar limit for benefits commencing at or after age 55 was not reduced below $75,000.[251] As a result, the dollar limit for benefits which commence *at any age* before the Social Security retirement age will be the actuarial equivalent of the inflation-adjusted limit ($90,000 for 1986) for benefits commencing at the Social Security retirement age.[252]

The adjustment of the dollar limit on benefits with respect to a participant who retires at or after age 62 and before the Social Security retirement age, is to be calculated in a manner consistent with the reduction for early retirement benefits under Social Security. Thus, for participants with a Social Security retirement age of 65, for example, early retirement will require a reduction equal to 5/9 of 1% for each month by which the individual's age at retirement precedes age 65. This results in a dollar limit equal to 80% of the maximum limit for normal retirement age for individuals who retire at age 62. Where the Social Security retirement age is 66, the dollar limit at age 62 is 75% of the maximum limit, and where the Social Security retirement age is 67, the dollar limit at age 62 is 70% of the maximum limit or $63,000.[253]

Benefits commencing prior to age 62 will be reduced to reflect the actuarial equivalent of the benefit payable at age 62. As under pre-1986 TRA law, the reduction is computed using an interest rate assumption not less than the greater of 5% or the rate specified in the plan for purposes of determining early retirement benefits.[254]

These provisions, which conform the normal retirement age under a plan to the Social Security retirement age, and also provide an early retirement reduction consistent with the Social Security reduction for early retirement, apply for purposes of both the dollar limit on benefits under a defined benefit plan and for purposes of determining the employer's allowable deduction for funding such benefits.[255]

Note: These provisions do not affect either the time at which plan participants may retire, nor do they directly affect the employer's assumptions for funding purposes concerning the time at which participants will retire. These provisions affect only individuals whose benefits exceed the dollar limits on benefits and, as a result, do not require an actuarial reduction for early retirement benefits for all participants whose benefits commence before the Social Security retirement age.[256]

The Act also modified the pre-TRA rule that permitted an increased §415 limit for benefits commencing after age 65. Under the revised provision, if retirement benefits from a defined benefit plan begin after the Social Security retirement age, the dollar limit is increased so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at *the Social Security retirement age.* As under pre-1986 TRA law, the increase is computed using an interest rate assumption not higher than the lesser of 5% or the rate specified in the plan.

c. Reduction for Service Less Than Ten Years

The 1986 TRA reduces the maximum dollar limit for participants with fewer than 10 years of *participation* in a

[246] Act §1106(a). Code §415(d).
[247] Act §1106(b)(1). Code §415(b)(2).
[248] Act §1106(b)(1)(B). Code §415(b)(8). For a discussion of the modifications, *see* Senate Rep., p. 624.
[249] §216(l) of the Social Security Act, as modified by Code §415(b)(8). *See* Senate Rep., p. 624.
[250] Act §1106(b)(1)(A) amending Code §415(b)(2)(C). Senate Report, p. 623.
[251] Act §1106(B)(1)(A). Code §415(b)(2).
[252] Senate Rep., p. 624.
[253] Senate Rep., pp. 624-25.
[254] Senate Rep., p. 625.
[255] *Id.*
[256] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

defined benefit plan.[257] Under pre-TRA law, the 10-year period related to years of service with the employer rather than years of participation in the defined benefit plan in question. The amendment discourages the establishment of defined benefit plans for top executives in the last few years before retirement. Where a plan is established close to retirement, so that the employee does not have 10 years of participation, the dollar limit is reduced ratably.[258] The proration, however, may not reduce the limit to an amount less than one-tenth of the dollar limit (*i.e.*, $9,000).[259] Service with the employer before becoming a participant, however, is disregarded in determining the §415 dollar limits on benefits payable under a defined benefit plan.

Example: If a participant, who would otherwise be entitled under the terms of the plan to receive the maximum annual benefit, had only three years of participation in the plan, the maximum benefit payable would be the lesser of 100% of compensation (reduced by 10% for each year of service less than 10), or $27,000 (three-tenths of $90,000).

The Act also provides that, to the extent provided in regulations, this proration will not only be applied to newly-formed plans (*i.e.*, plans formed within 10 years of retirement), but also to each change increasing benefits under a plan.[260] The Conference Report provides that an amendment improving the benefit formula may increase benefits by up to 1/10 of the §415 dollar limit for each year of participation after the amendment. A second amendment within 10 years of a prior amendment increasing benefits is subject to the limit under the phase-in triggered by the prior amendment (along with benefit increases under the prior amendment).[261]

The Conference Report provides that the phase-in for benefit increases does not apply to benefit improvements due to updating compensation in a career average pay plan, cost-of-living increases for retirees, the beginning of a new collective bargaining cycle, and other reasonable benefit improvements that are not primarily for the highly compensated employees.[262] The Conferees directed the Secretary to draft regulations to apply a concentration test under which the phase-in will apply to a benefit increase if the resulting increase in benefits is not primarily for highly compensated employees. The Secretary was also directed to provide rules permitting the tacking of participation under separate plans in circumstances not inconsistent with the purposes of the phase-in.[263]

d. Specialized Dollar Limit Rules

(1) Plans Maintained by Governments and Tax-Exempt Organizations

The Act contains special rules for tax-exempt or governmental employers and a specified class of merchant seamen. The Act exempts these classes from the provisions relating to the normal retirement age and the elimination of the $75,000 floor for benefits beginning at age 55.[264] Thus, for plans that qualify under this exception, the dollar limit applicable to benefits commencing at age 62 remains $90,000. For benefits commencing before age 62, the limit is reduced to an amount actuarially equivalent to a benefit of $90,000 commencing at 62. As under pre-1986 TRA law, actuarial equivalence is determined using an interest rate equal to 5% or the rate specified in the plan, whichever is greater. For plans qualifying for this exception, the limit on benefits commencing on or after age 55 will not be reduced to an amount less than $75,000 and, for benefits commencing before age 55, the applicable dollar limit is the actuarial equivalent of the $75,000 limit commencing at age 55.[265]

A governmental plan is defined as a plan within the meaning of Code §414(d). That section relates to plans established and maintained for its employees by the United States, the government of any state or political subdivision of a state or by any agency or instrumentality of any state or the federal government. A governmental plan also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies and any plan of any international organization which is exempt from tax by reason of the International Organizations Immunities Act.[266] Also covered under these provisions, is a "qualified merchant marine plan," defined as a plan in existence on January 1, 1986, in which the participants are merchant marine officers holding licenses issued by the Secretary of Transportation under Title 46 of the U.S. Code.[267]

(2) Special Limits for Qualified Police and Firefighters

Many governments require their police and firemen to retire at an age earlier than the Social Security retirement age. As a result, Congress did not believe it appropriate to provide for full actuarial reduction of the limit on benefits payable to participants in certain police and firefighter pension plans.[268] The Act limited the actuarial reduction of the limit on benefits payable to participants in qualified police or firefighters pension plans so that the benefits will never be actuarially reduced to an amount less than $50,000, regardless of the age at which the benefits commence. In addition, the Act's provisions conforming the retirement age, for purposes of the limits on benefits, to the Social Security retirement age, and modifying the actuarial reductions for early retirement, do not apply to such plans or to benefits provided to police officers and firefighters.[269] Further, the $50,000 amount below which benefits may not be actuarially reduced, will be adjusted at the same time and in the same manner as the $90,000 limit for defined benefit plans in accordance with increases in the consumer price index.[270]

[257] Act §1106(f). Code §415(b)(5).
[258] *Id.*
[259] Act §1106(f). Code §415(b)(5)(C).
[260] Act §1106(f). Code §415(b)(5). Code §415(b)(5)(D).
[261] Conf. Rep., pp. II-475-76.
[262] Conf. Rep., p. II-476.
[263] Conf. Rep., p. 476.
[264] Act §1106(b)(2). Code §415(b)(2)(F).
[265] *Id.*
[266] Code §415(b)(2)(F).
[267] Act §1106(b)(2). Code §415(b)(2)(F).
[268] Senate Rep., p. 625.
[269] Act §1106(b)(2). Code §415(b)(2)(G).
[270] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

A qualified participant is defined as a participant in a defined benefit plan maintained by a state or a political subdivision, and for whom the calculation of the period of service taken into account in determining the amount of the benefit in the defined benefit plan includes at least 20 years of service of the participant as a full-time employee of any police department or fire department, which is organized and operated by a state or political subdivision maintaining the defined benefit plan or as a member of the armed forces of the United States.[271] Correction officers, although covered under the Senate bill, were not included in the provision that was enacted.[272]

(3) Commercial Pilots

Commercial pilots were also given special treatment primarily because federal regulations require that commercial airline pilots retire at age 60 and Congress did not believe it appropriate to apply an actuarial reduction for early retirement where an individual is required to retire at an earlier age.[273]

The Act retained the $75,000 floor of pre-1986 TRA law for benefits commencing at or after age 55.[274] If benefits begin before age 55, the actuarial reduction for early retirement may not reduce the limit on benefits below the actuarial equivalent of the $75,000 limit at age 55.[275]

The Act also provided that if, as of the time an individual retires, Federal Aviation Administration (FAA) regulations require an individual to separate from service as a commerical airline pilot after attaining any age occurring on or after age 60 and before the Social Security retirement age, the age specified in the FAA regulations must be substituted for the Social Security retirement age, unless the individual separates from service before reaching age 60.[276]

The Conference Report clarifies that the rules applicable to commercial pilots are limited to individuals whose service as a pilot constitute substantially all of their service to which the benefit relates.[277]

3. Qualified Cost-of-Living Arrangements

The Act introduced an arrangement that may be established in conjunction with a defined benefit plan. Under this arrangement, special employer and employee contributions may be used to provide cost-of-living increases in addition to the primary retirement benefit, after the annuity starting date. To qualify, such arrangements must meet certain election requirements, additional nondiscrimination requirements, special rules for key employees, and the general qualification requirements of Code §401(a).[278]

A qualified cost-of-living arrangement is an arrangement in conjunction with a defined benefit plan that (1) provides a cost-of-living adjustment to a benefit provided under the defined benefit plan or a separate plan that is subject to the minimum funding standards of Code §412; and (2) meets four specific requirements and any other requirements set forth in regulations.[279] Under a qualified arrangement, employee contributions are not treated as annual additions for purposes of the defined contribution plan §415 limit. They are, however, treated as an annual addition for purposes of the combined plan limit of Code §415(e).[280] The benefit attributable to the employee contribution, however, will be treated as an employer-provided benefit for purposes of Code §415(b).[281]

The requirements that must be satisfied for an arrangement to qualify as a cost-of-living arrangement are:

(1) The cost-of-living adjustment of participants must be based (i) on increases in the cost-of-living after the annuity starting date, and (ii) on the average cost-of-living increases must be determined by reference to one or more indices prescribed by regulations, except that the arrangement may provide that the increase for any year will not be less than 3% of the retirement benefit (determined without regard to the arrangement).[282]

(2) The cost-of-living arrangement must be elective and available to all participants.[283] The arrangement must provide that the election may be made in the year in which the participant separates from service or attains the earliest retirement age under the defined benefit plan, or it may provide that the election may be made in both such years.[284]

(3) The arrangement must not be found under regulations or by the Secretary to create a pattern of discrimination with respect to participation therein.[285]

(4) In general, qualified arrangements may not permit key employees to participate. For this purpose, a key employee is defined under Code §416(i), except that for non top-heavy plans, officers who are key employees solely by reason of their officer status may participate.[286]

The legislative history clarifies that a qualified cost-of-living arrangement must satisfy *all* of the applicable qualification requirements of Code §401(a). For example, the right to the employer-provided portion of a cost-of-living benefit under a qualified arrangement is part of the accrued benefits subject to the Code §411 benefit accrual rules, including the Code §411(d)(6) anti-cutback rule, and, as a result, it will accrue and vest as the employee accrues and vests in the normal retirement benefit. Thus, an employer may reduce or eliminate the employer contribution under a qualified cost-of-living arrangement only with respect to benefits not yet accrued.[287] The right to the employer-derived portion of a qualified cost-of-living benefit is also subject to the vesting requirements. Employer-derived benefits are to be treated under rules similar to the

[271] Act §1106(b)(2). Code §415(b)(2)(H).
[272] *Id.*
[273] Senate Rep., p. 625.
[274] Act §1106(b)(3). Code §415(b)(9)(A).
[275] *Id.*
[276] Act §1106(b)(3). Code §415(b)(9)(A)(ii).
[277] Conf. Rep., p. II-475.
[278] Act §1106(c). Code §415(k)(2).
[279] Act §1106(c). Code §415(k)(2)(B).
[280] Act §1106(c). Code §415(k)(2)(A)(i).
[281] Act §1106(c). Code §415(k)(2)(A)(ii). *See also,* House Rep., p. 745.
[282] Act §1106(c). Code §415(k)(2)(C).
[283] Act §1106(c). Code §415(k)(2)(D).
[284] *Id.*
[285] Act §1106(c). Code §415(k)(2)(E).
[286] Act §1106(c). Code §415(k)(2)(F).
[287] House Rep., p. 744.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

rules applicable to employer-derived early retirement benefits.[288] For example, according to the Conference Report, "the employer-derived portion of the cost-of-living benefit need not be provided to an employee who fails to satisfy the applicable conditions for receipt of the benefit, including any required employee contributions. Further, the cost-of-living benefit need not be provided to an employee who has separated from service and received a distribution of the employee's benefit without making the required contributions for the cost-of-living benefit. The employee could, however, return to service and buy back the benefit by proper repayment of the cashed out benefit." [289]

Cost-of-living increases must be available on the same terms for all participants. Thus, a greater subsidy could not be provided for employees who work until retirement than to those who separate from service with vested benefits before retirement.[290]

Note: For purposes of the lump sum distribution rules under Code §402(e)(4), the balance to the credit of an employee under a defined contribution plan does not include any amount transferred from such defined contribution plan to a qualified cost-of-living arrangement under a defined benefit plan.[291]

4. Limit on Annual Compensation

The 1986 TRA replaced the $200,000 compensation limit applicable to top-heavy plans and SEPs with a $200,000 limit for *all* participants regardless of whether they are key employees and regardless of whether the plan is top-heavy.[292]

Note: The limit applies for most purposes including the §404 provisions relating to allowable deductions and the nondiscrimination rules.[293] As a result, contributions and benefits must be based on no more than the first $200,000 of compensation each year. Thus, for a nonintegrated plan to provide the maximum dollar contribution to a defined contribution plan ($30,000 in 1986, for instance) for its highly paid participants, it would have to provide for a contribution rate of 15%.

Note: The Conference Report provides that the $200,000 limit applies to each year's compensation (including years before 1987), not solely to the final average or career average compensation of an individual.[294]

Regulations are required that will effectuate the intent of the $200,000 limit. According to the Senate Report, the purpose is to ensure that reductions in the maximum contributions or benefits do not reduce the contributions or benefits of low- and middle-income employees.[295] As a result, it would be inconsistent with this intent to define compensation so that the $200,000 limit has little effect on highly compensated employees, but the definition adversely impacts in low- and middle-income employees.[296] The $200,000 annual compensation limit will be indexed in the same manner and at the same time as the $90,000 defined benefit dollar limitation under Code §415(d).[297]

The Conference Report clarifies that, with regard to a defined benefit plan, the $200,000 limit applies to each year's compensation (including years before 1987), not solely to the final average or career average compensation of an individual.[298]

5. Code Section 415 Limits May Be Incorporated in Plans by Reference

The 1986 TRA provides that, except as provided in regulations and notwithstanding any other provision of law, a plan may incorporate by reference the §415 limits.[299]

While incorporation by reference is permitted, if the limit may be applied in more than one manner, the plan must specify the manner in which the limit is to be applied.[300] For example, for defined contribution plans, regulations provide several methods for establishing a suspense account for excess annual additions and for allocating amounts in the suspense account. Under the 1986 TRA, although the plan may incorporate the limit by reference, it must specify which method is to be used.[301] The Act does not change the requirements of pre-TRA law relating to definitely determinable benefits and the requirement that profit sharing and stock bonus plans specify a definite allocation formula. A plan will not fail to provide definitely determinable benefits merely because it incorporates the §415 limits by reference but, if an employee participates in both a defined contribution plan and a defined benefit plan maintained by the same employer, the manner in which the employee's benefits will be adjusted to comply with the §415(e) combined plan limit must be specified.[302]

6. Special Catch-Up Election for Tax-Sheltered Annuity Plans

The 1986 TRA amended the catch-up rules for tax-sheltered annuity plans under which an employee of certain specified institutions may elect to compute the annual exclusion allowance solely by reference to the maximum annual employee payment that could be made under the overall limit. The Act expanded the class of employers whose employees are entitled to the special catch-up elections to include health and welfare service agencies.[303] The Conference Report clarifies that the catch-up rules apply *before* separation from service.[304]

7. Planning Tip

The 1986 TRA changes to Code §415 generally apply to years beginning after December 31, 1986. Plan amendments are not required, however, until the first plan year

[288] Conf. Rep., p. II-476.
[289] *Id.*
[290] House Rep., p. 744.
[291] Act §11006(c)(2). Code §402(e)(4)(N).
[292] Act §1106(d). Code §401(a)(17) and Code §404(l).
[293] That is, Code §§401(a)(4), 401(a)(5), 401(k)(3), 401(l), 401(m), and 408(k).
[294] Conf. Rep., p. II-428.
[295] Senate Rep., p. 628.
[296] *Id.*
[297] Act §1106(d)(1) and (2).
[298] Conf. Rep., p. II-478.
[299] Act §1106(h).
[300] Conf. Rep., p. II-478.
[301] *Id.*
[302] Conf. Rep., p. II-479.
[303] Act §1106(b)(4). Code §415(c)(4)(A), (B) and (C).
[304] Conf. Rep., p. II-477.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

beginning after December 31, 1988.[305] Nevertheless, employers with defined benefit plans should amend their plans to conform to the revised §415 limits as soon as possible. Under ERISA, which has not been amended by the 1986 TRA with regard to the contribution and benefit limits, benefits must accrue and the minimum funding standard must be met based on the terms of the plan document. If the plan provides for benefits in excess of the Act's requirements after the effective date of the changes, the plan's terms control and benefit accruals cannot be reduced by future amendment, even though amendments are not required until 1989. Also, deductions in excess of the required limits are subject to a penalty tax. A failure to amend the plan by the effective date of the 1986 TRA provisions may result in participants accruing benefits in excess of the limits, possibly causing the funding of excess benefits on a nondeductible basis and the imposition of a 10% excise tax on nondeductible contributions under §4972.[306]

8. General Effective Dates

a. In General

In general, the changes to Code §415 apply for limitation years beginning after 1986. Also, in general, in the case of plans maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers and ratified before March 1, 1986, the amendments to §415 do not apply to contributions or benefits pursuant to such agreements in years beginning before the earlier of January 1, 1989 or the date on which the last of the agreements terminates.[307]

There is a different effective date rule for the $200,000 annual limit on compensation. The $200,000 limit applies for benefits accruing in years beginning after 1988.[308] In the case of a collectively bargained plan, the amendments concerning the $200,000 compensation limit apply to benefits accruing in years beginning on or after the earlier of: (i) January 1, 1991, or (ii) the later of (a) January 1, 1989 or (b) the date on which the last of the collective bargaining agreements ratified before March 1, 1986 terminates.[309]

b. Transition Rules

(1) Benefits Accrued Before 1989

Beginning January 1, 1987, employer deductions for contributions to qualified plans are limited to amounts required to fund benefits subject to the reduced limits. The benefits that accrue under a plan, or the annual additions that are allocated to the plan, in excess of the reduced limits will have to be decreased to comply with the limits unless the benefits are grandfathered as "current accrued benefits."[310]

A current accrued benefit is the participant's accrued benefit determined as of the close of the last limitation year beginning before January 1, 1987. The accrued benefit must be expressed as an annual benefit determined pursuant to the rules in effect under pre-1986 TRA law. Generally, the current accrued benefit is determined pursuant to the terms and conditions of the plan. If there are any changes in the terms or conditions of the plan after May 6, 1986, they may not be taken into account. The current accrued benefit for this purpose, will not be increased by cost-of-living increases occurring after 1986.[311]

This transition rule allows individuals who were participants in a plan before January 1, 1987, provided the plan was in existence on May 6, 1986, to accrue a higher defined benefit than would be permitted under the 1986 TRA rules. This grandfather provision assures that the dollar limit for benefits payable under the plan is never less than the benefit accrued as of the end of the last limitation year beginning before January 1, 1987.[312]

(2) Rules Pertaining to Plans that Exceed Combined Fraction Rule

A transition rule applies to plans that satisfied the post-1986 TRA §415 requirements for their last years beginning in 1986. With regard to these plans, the Act requires that regulations be promulgated under which an amount is subtracted from the numerator of the defined contribution plan fraction (not exceeding the numerator) so that the sum of the defined benefit plan fraction and the defined contribution plan fraction computed under Code §415(e)(1) does not exceed 1.0 for such year.[313] The proposed enrollment technical corrections to this provision, which were not enacted, indicated that the computation should be determined as if the amendments made by the Act were in effect for such year.

III. 401(k) and Thrift Plans

A. Introduction

1. Cash or Deferred Arrangements

Section 401(k) of the Code was enacted by the Revenue Act of 1978.[314] Regulations under §401(k) were first proposed on November 10, 1981.[315] These proposed regulations have not yet been finalized.

Since the regulations were proposed under §401(k), cash or deferred arrangements (CODAs) have become widely used by employers because of their ability to allow tax benefits for salary reduction contributions made by employees to the plan. Section 401(k) plans are required to both satisfy the general nondiscrimination requirements for all qualified plans,[316] and must also satisfy the special requirements of §401(k).

One of the principal limitations imposed by §401(k) plans are the limitations on contributions that can be allocated to the highest paid group. This limitation is calculated by reference to the actual deferral percentages (ADP) of the employees eligible to participate in the plan. Under the rules as they existed before the Tax Reform Act

[305] Act §1140.
[306] *See* Act §1131(c)(1). Code §4972(a).
[307] Act §1106(i)(2).
[308] Act §1106(i)(5)(A).
[309] Act §1106(i)(5)(B).
[310] Act §1106(i)(3).
[311] *Id.*
[312] *Id.*
[313] Act §1106(i)(4).
[314] Revenue Act of 1978, §135.
[315] *See* Prop. Regs. §1.401(k)-1.
[316] *See* §§401-417.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

of 1986, the eligible employees were grouped by compensation and the ADP of the lower paid two-thirds was measured against the ADP of the upper paid one-third. Under this test, the ADP of the eligible employees in the top one-third group could not exceed:

(1) the ADP for the lower paid two-thirds multiplied by 1.5; or

(2) the ADP of the lower paid two-thirds multiplied by 2.5 but with the ADP of the upper paid one-third not to exceed the ADP of the lower paid two-thirds by more than three percentage points.[317]

Example: Under this test, if the ADP of the lower paid two-thirds were 6%, then the ADP of the upper paid one-third could not exceed 9%.

Within these limits, however, the only other dollar limitations applicable to the deferrals available under §401(k) were the same limitations applicable to qualified plans. Thus, for example, because §401(k) plans were generally profit-sharing plans, they were subject to the limitations of §415(c) and, thus, the total annual additions for an individual for a year could not exceed 25% of compensation or $30,000.[318]

2. After-Tax Employee Contributions

Before the Tax Reform Act of 1986, the only nondiscrimination requirements applicable to after-tax employee contributions to a qualified plan were general requirements to ensure that the plan was not excessively used for the benefit of the highly-compensated employees. The principal limitation imposed to ensure that this reasonableness requirement was satisfied is the imposition of a broad 10% of compensation limit on the amount of aggregate after-tax employee contributions that can be contributed by an employee to a plan over his years of participation.[319] Mandatory employee contributions are however, subject to a lower limitation of 6% of compensation.[320]

B. Overview

1. Limitations on Elective Contributions

Act §1105 adds new limitations on the amount of elective deferrals that an individual can make on a tax-deferred basis. These new limitations are imposed under new §402(g), which generally imposes a $7,000 limit on the amount of elective deferrals that any individual can make during a calendar year and have the amount excluded from his gross income. As used in the statute, "elective deferral" includes salary reduction contributions to a qualified CODA under §401(k) (which would otherwise be excludable from income under §402(a)(8)), salary reduction contributions to a tax-sheltered annuity under §403(b) and salary reduction contributions made to a simplified employee pension plan of a type similar to the cash or deferred profit-sharing plan.

If an individual makes an elective deferral in excess of $7,000 for a taxable year, the amount is included in the gross income of the individual for the year in which the deferral is made. If the excess deferral is separately allocated by the first day of March following the taxable year of the deferral and actually distributed by the following April 15, then the excess deferral will not be included in the individual's income in the year withdrawn from the plan, although the earnings on the excess deferral will be taxable for the year of withdrawal. In addition, the withdrawal will not be subject to the penalty tax under §72(t), even if the individual has not yet reached age 59½ at the time of the withdrawal.

Any excess deferral that is not timely withdrawn is not treated as part of the investment in the contract under §72 and therefore would not increase the individual's basis under the plan. Thus, failure to make a timely withdrawal pursuant to the provisions of §402(g)(2) would result in double taxation of the excess deferral.

The $7,000 limit under §402(g)(1) is increased to the greater of $9,500 or the $7,000 limit as adjusted for cost-of-living increases for contributions to tax-sheltered annuities under §403(b). The $7,000 limit is adjusted for cost-of-living in the same manner as adjustments are made under §415(d).

These new limitations apply to taxable years beginning after 1986. Thus, they are generally effective for calendar years starting January 1, 1987. Two special rules are provided that are of particular importance. First, elective deferrals by a partner for a taxable year beginning before January 1, 1987 and ending after January 1, 1987 are treated as having been made ratable during the taxable year.

The second special rule provides that employer contributions made to a CODA during 1987 that are attributable to services performed during 1986 are not subject to these new limitations if, under the plan as in effect on August 16, 1986, the employee makes the election before January 1, 1987 and the employer identifies the amount of the contribution before January 1, 1987.

2. Antidiscrimination Rules Under Section 401(k)

Act §1116 makes several substantial changes in the nondiscrimination rules applicable to CODAs under §401(k).

Probably the most significant of these changes is a change in the nondiscrimination percentages (ADPs) applicable under §401(k)(3). Under pre-1986 TRA law, these ADPs are computed separately for the highly-compensated employees and for the nonhighly-compensated employees. Under the Act, the ADP formula would be reduced so that the ADP of the highly-compensated employees cannot exceed 1.25 times the ADP of the nonhighly-compensated employees or, if greater, two times the ADP of the nonhighly-compensated eligible employees but not more than two percentage points greater than the ADP of the nonhighlycompensated eligible employees.

Failure to comply with the nondiscrimination rules of §401(k)(3) will not necessarily lead to the disqualification of the plan. Under §401(k)(8), if the excess contributions are distributed to the participants in a timely fashion, disqualification is avoided. Alternatively, pursuant to regu-

[317] §401(k)(3) before the Act.
[318] *See* §415(c).
[319] Rev. Rul. 80-350, 1980-2 C.B. 133.
[320] Rev. Rul. 72-58, 1972-1 C.B. 111.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

lations, the employee may elect to treat the excess contribution as an after-tax employee contribution, thereby potentially avoiding plan disqualification. In order to gain the protection of §401(k)(8), the excess contribution must be either distributed or recharacterized as an after-tax employee contribution before the close of the plan year following the year in which the excess contribution is made. If such a distribution is made or recharacterized, then the 10% excise tax on distributions before age 59½ under §72(t) will not be imposed.

Two other fundamental changes in the application of the nondiscrimination rules to plans under §401(k) are made by the Act. First, §414(s) is added to define compensation for purposes of §401(k) as well as for qualified plans generally. Second, the highly-compensated group will no longer consist of the highest-paid 1/3 of eligible employees but instead, will be calculated pursuant to a special Code provision, §414(q). Under §414(q), which will apply to all qualified plans, "highly-compensated employee" generally includes 5% shareholders, employees making over $75,000 a year, employees making over $50,000 a year who are in the top 20% of employees by pay, employees who are officers and make more than $45,000 a year (1½ times the dollar limit for defined contribution plans under §415(c)) and family members of any of the foregoing.

3. Antidiscrimination Rules for Thrift Plans

Act §1117 imposes special nondiscrimination rules on matching contributions and employee contributions in thrift plans. These new nondiscrimination requirements are imposed under new Code §401(m), which is similar to §401(k) in the tests imposed.

The principal nondiscrimination test imposed under §401(m) is very similar to the ADP test imposed under §401(k). Instead of using actual deferral percentages, §401(m) uses contribution percentages. Contribution percentages are computed for the eligible highly-compensated employees and for all other eligible employees separately. The contribution percentages for each group are the average of the ratios of the sum of the matching contributions and employee contributions paid under the plan on behalf of each employee over each employee's compensation. (Compensation is defined under new Code §414(s)). The statute indicates that pursuant to regulations, elective deferrals and qualified nonelective contributions may be taken into account for purposes of this test. Qualified nonelective contributions include employer contributions (other than matching contributions) that are not elective and that satisfy the vesting and distribution requirements of §401(k)(2)(B) and (C).

Once computed, the contribution percentages for the cligible highly-compensated employees on average cannot exceed the greater of:

(1) 125% of that percentage for all other eligible employees; or

(2) the lesser of (a) 200% of that percentage for all other eligible employees or (b) the percentage for all other eligible employees plus two percentage points.

In calculating these percentages, all employees who are eligible to make either employee contributions or to receive matching contributions are considered eligible employees.

If excess contributions are made to employees, a correction procedure similar to that provided under §401(k) is provided for plans covered by §401(m). That is, if the excess aggregate contributions are withdrawn before the close of the following plan year, the plan is not disqualified. If the excess aggregate contributions are withdrawn in a timely fashion, then the tax on early distribution under §72(t) will not be imposed.

The provisions of §401(m) are effective for plan years beginning after 1986.

4. Excess Contributions

In order to provide stronger disincentives for employees to make excess contributions under §401(k) or §401(m), a new excise tax under §4979 is imposed on excess contributions. The tax is imposed on the employer in an amount equal to 10% of the sum of the excess contributions under a CODA or the excess aggregate contributions under a §401(m) plan. The tax also is imposed on excess contributions under tax-sheltered annuities under §403(b) and cash or deferred SEPs under §408(k). This 10% excise tax can be avoided if the excess contributions are distributed before the close of the first 2½ months of the following plan year. Failure to make the distribution within that time period would lead to imposition of the tax. Distributions within this 2½ month period are treated as received and earned by the recipient in the earlier taxable year.

This new excise tax is effective for plan years beginning after 1986.

5. Other Rules

Several other changes to §401(k) are made by the Act. First, the rules of §401(k)(2)(B) are modified to permit distributions to be made from a §401(k) plan on events other than separation from service, death, disability, age 59½ or hardship. Under this provision, §401(k) plans may make distribution on termination of the plan without establishment of a successor plan, the sale by the corporation of substantially all the assets used in its trade or business, the sale by a corporation of its interest in the subsidiary with respect to an employee who continues employment with that subsidiary, attainment of age 59½ in the case of a profit-sharing or stock bonus plan and the hardship of an employee in the case of a profit-sharing or stock bonus plan.

In addition, the waiting period for eligibility to participate in a §401(k) arrangement would be limited to not more than one year of service.

Note: This requirement will cause substantial problems for many small employers that use §401(k) plans since such plans, in many cases, require three years of service and provide a fully-vested employer contribution to meet the qualification requirements of §401(k).

In addition, §401(k) plans are not permitted to condition any benefit other than matching contributions on the employee's decision whether to make elective contributions to the plan. For example, a plan could not require that an

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

employee make a minimum elective contribution to the plan in order to receive an employer contribution under the plan. The plan could, however, have matching contributions that are only made if employees make elective contributions.

Section 401(k) plans can no longer be adopted by states, local governments, political subdivisions, agencies or instrumentalities of those entities or any organization exempt from income taxes (under subtitle A of the Code).

6. Effective Date

The general effective date rule for these changes is for years beginning after 1988. However, the reduction in the ADP percentages, the requirement that benefits not be contingent on elective contributions, the new definitions of highly-compensated employee and compensation, and the provisions on prohibiting the adoption of §401(k) plans by state and local governments and tax-exempt employers are applicable for years beginning after 1986. A special exception provides, however, that for state and local governments and political subdivisions that adopted a §401(k) plan before May 6, 1986 or tax-exempt organizations that adopted a §401(k) plan before July 2, 1986, the new prohibitions do not apply. Also, the special rules on the treatment of excess contributions apply for years beginning after 1986.

C. Detailed Analysis

1. Limits on Elective Deferrals

One of the major changes for §401(k) and other salary reduction arrangements is the imposition of tax limits on the amount that an individual can defer on a salary reduction basis to a plan.[321] These limits are imposed on §401(k) CODAs, §403(b) tax-sheltered annuities, and salary reduction simplified employee pension plans under §408(k).

a. Dollar Limits

New §402(g) imposes dollar limitations on the elective deferrals that an individual can make for any taxable year.[322] That is, if an individual makes an elective deferral in excess of the applicable limit, then the excess amount is nevertheless taxable to the individual for the year of the deferral.

The general limitation on the amount of deferral allowable is $7,000 a year.[323] This amount is subject to cost-of-living adjustments in accordance with the rules applicable to pension plans.[324] Further, in the case of amounts contributed under tax-sheltered annuities under §403(b) contracts, the dollar limitation is $9,500 instead of $7,000, but the $9,500 figure is not adjusted for cost-of-living increases.[325]

These limitations apply to the "elective deferrals" made with respect to any taxable year The term "elective deferral" includes three types of contributions. First, it includes employer contributions under a qualified CODA under §401(k) that are not includable in income by reason of §402(a)(8).[326] Thus, in essence, this limitation on elective deferrals in §401(k) plans only applies to the employee's salary reduction contributions, not to the employer contribution or the matching contribution made by the employer.

Example: In 1987, an executive, who in the past has been participating in a §401(k) plan to the extent of $30,000 in salary reduction contributions, will nevertheless be taxable on $23,000 of those salary reduction contributions if he puts in as a salary reduction contribution more than $7,000 in that calendar year. However, if the corporation contributes amounts in excess of $7,000, it is not affected by the limits of §402(g).

Second, "elective deferral" applies to employer contributions to the extent not includable in gross income for the taxable year under §402(h)(1)(B). This provision is applicable to salary reduction contributions made to a simplified employee pension plan under §408(k).[327]

Third, employer contributions used to purchase an annuity contract under §403(b) under a salary reduction agreement within the meaning of §3121(a)(5)(D) are also treated as elective contributions.[328]

A special rule applies for certain "qualified organizations." Qualified organizations include educational organizations, hospitals, home health service agencies, health and welfare service agencies, churches (or conventions or associations of churches) and any organization described in §414(e)(3)(B)(ii).[329] Under these special rules, a "qualified employee," *i.e.*, an employee who has completed 15 years of service with the qualified organization,[330] may make salary reduction contributions to a level higher than those otherwise permitted by §402(g). The applicable limitation for the salary reduction contributions to the tax-sheltered annuity contract is increased by whichever of the following is the least:

(1) $3,000;

(2) $15,000 reduced by amounts not included in gross income for the prior year by reason of these provisions; or

(3) the excess of $5,000 multiplied by the number of years of service of the employee with the qualified organization over the salary reduction contributions made for such employee for prior taxable years.[331]

These rules in effect permit certain long-serviced employees of educational organizations, churches and health related entities a larger salary reduction contribution to a tax-sheltered annuity.

b. Treatment of Excess Contributions

Section 402(g) also establishes tax rules for the treatment of excess deferrals, *i.e.*, amounts deferred in excess of the limits set forth under §402(g)(1). As noted previously, the excess deferral is taxable to the individual in the year of

[321] Act §1105.
[322] §402(g)(1).
[323] *Id.*
[324] The adjustment is made in accordance with the adjustments under §415(d). §402(g)(5).
[325] §402(g)(4).
[326] §402(g)(3)(A).
[327] §402(g)(3)(B).
[328] §402(g)(3)(C).
[329] §402(g)(8)(B).
[330] §402(g)(8)(C).
[331] §402(g)(8)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the deferral since no salary reduction exclusion is permitted.[332] In addition, any excess deferral that is not distributed from the plan during the taxable year of the deferral is not treated as "an investment in the contract" under §72.[333] As a result, the employee will not establish any basis in the plan from the excess deferral and subsequent distribution of that amount would be potentially taxable.

Special rules on the distribution of excess deferrals are provided in §402(g). These special rules contemplate a two-step procedure for the distribution of an excess deferral held by a plan. Under the first step, not later than the first March 1 following the close of the taxable year of the individual, the individual may allocate the amount of the excess deferral among the plans under which the deferrals were made and may notify the plans of the portion allocated to them. If only one plan is involved, this step would be unnecessary. If, however, excess deferrals were made to more than one plan, the employee would have to determine which plan contained the excess deferral and follow the procedures of this first step.

The second step would require that not later than the first April 15 following the taxable year of the excess deferral, each of the plans may distribute to the individual the amount allocated under that plan as an excess deferral. That distribution would have to include any income allocable to the excess deferral as well.[334] That distribution is permitted by the plan notwithstanding any other provision of law.[335]

Note: Because of the sweeping language permitting the distribution to be made notwithstanding any other provision of law, it would appear that the fiduciaries would be protected against fiduciary responsibility for permitting such a distribution to be made even though it might arguably otherwise violate Title I of ERISA. Note, however, that the distribution from the plan is permissive, not mandatory. As a result, it appears that the plan could determine whether or not to make the distribution to an individual of an excess deferral even though the individual had requested it.

A distribution made in accordance with these procedures is exempt from being included in gross income for income tax purposes and is also exempt from the early distribution tax imposed under §72(t). Further, the income on the excess deferral is treated as earned and received in the taxable year in which the excess deferral is made.[336] For purposes of §401(k), however, the excess deferral shall be treated as an employer contribution in determining the actual deferral percentage limits under §401(k)(3)-(A)(ii).[337]

Note: The 1986 TRA does not specifically address the treatment of these excess amounts for payroll taxes. Although the employer would be required to report these excess deferrals, presumably on the employee's Form W2,[338] no specific provision dealing with payroll taxes is included.

c. Effective Dates

The general effective date rule for these provisions is for taxable years beginning after December 31, 1986.[339] Since they apply to individuals rather than plans, this will generally mean that the new rules are applicable beginning with the calendar year 1987.

For plans maintained pursuant to collective bargaining agreements ratified before March 1, 1986, the effective date shall not apply to contributions made pursuant to the agreement for taxable years beginning before the earlier of:

(1) the date on which the last collective bargaining agreement terminates (determined without regard to extensions after February 28, 1986); or

(2) January 1, 1989.

Note: The justification for delayed effective dates for collective bargaining agreements is unclear since the provisions of §1105(c) only apply to elective contributions and are only tax rules, not plan rules, applicable to the individual.

The Act also provides special rules to facilitate the amendments authorized by the provisions of §402(g)(2). If a plan amendment is necessary in order to make the distributions authorized by §402(g)(2), then any distribution made before the close of the first plan year for which the amendment is required to be in effect shall be treated as made in accordance with the provisions of the plan as long as the amendment is made in accordance with the provisions of Act §1140, which generally allows plans to delay amendments until years beginning after 1988 as long as the amendment is retroactive to the required effective date and the plan operates in accordance with the amendment for the interim period.[340] Further, the Secretary of the Treasury or his delegate is specifically authorized to establish a model amendment to authorize the types of distributions provided in §402(g)(2) and any distribution made in accordance with such model amendment shall be treated as made in accordance with the provisions of the plan.[341]

The effective date rules also provide a special rule for partnerships. Under this rule, if the partnership year begins before January 1, 1987 and ends after January 1, 1987, *i.e.*, it is a fiscal year beginning in 1986 and ending in 1987, elective deferrals made on behalf of a partner for that taxable year are to be treated as being made ratably during the taxable year for purpose of §402(g)(3), which deals with the definition of elective deferrals. Thus, a partner who makes an elective deferral in 1987 that exceeds the $7,000 limitation would allocate part of the excess deferral to 1986, thereby reducing the amount of the excess deferral.

Example: A partnership has a fiscal year that ends on September 30, 1987. A partner during 1987 makes a $12,000 elective deferral to the §401(k) plan of the

[332] §402(g)(1)
[333] §402(g)(7).
[334] §402(g)(2).
[335] §402(g)(2)(A).
[336] §402(g)(2)(C).
[337] §402(g)(2)(B).

[338] Act §1105(b) amending §6051(a)(8).
[339] Act §1105(c)(1).
[340] Act §1105(c)(3)(A).
[341] Act §1105(c)(3)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

partnership. Even though made entirely in 1987 the contribution is treated as having been made ratably during the partnership year, which means that the contribution would be treated as having been made at the rate of $1,000 per month with the first $3,000 of elective contribution having been made during 1986. As a consequence, the excess deferral for the partner would only be $2,000 ($9,000 minus $7,000) instead of $5,000 ($12,000 minus $7,000).

Note, however, that this provision can produce the opposite result as well.[342] Thus, a partner in the above example who makes a $12,000 elective deferral in November 1986 might also have that contribution treated as having been made ratably during the partnership year thereby creating an excess deferral in 1987. This latter interpretation, however, was apparently not intended and regulations may eliminate this problem.

The final special effective date rule has to do with elective contributions made during 1987 but attributable to services performed during 1986. Under this special rule, if a §401(k) plan receives such an elective contribution pursuant to the terms of the plan as in effect on August 16, 1986 and the employee makes an election with respect to the contribution before January 1, 1987, and the employer identifies the amount of the contribution before January 1, 1987, then the amount is treated for purposes of Act §1105 as having been made during 1986. Thus, in effect, the $7,000 ceiling would be waived with respect to that contribution.

Note: This special rule does not alter the tax treatment of the elective contribution for purposes other than the limitations of §402(g). Thus, for purposes of calculating the limits under §401(k)(3) (the ADP limits), the compensation and the contribution would be considered to have been made in 1987.

2. *Antidiscrimination Requirements for Section 401(k) Plans*

The 1986 TRA restructured the antidiscrimination provisions of §401(k) to change both the tests themselves and the method of computing the tests. In particular, the method for determining the group whose ADP percentages are limited was redefined to make that group the highly-compensated employees instead of the upper one-third, the definition of compensation was changed, and the ADP limitations were modified.[343]

a. *Definition of Highly-Compensated*

Whereas the §401(k) rules previously tested the ADP limitations by reference to the ADP of the lower paid two-thirds of eligible employees versus the ADP of the upper paid one-third of employees, the 1986 TRA eliminated this testing mechanism, substituting instead the general definition of highly-compensated employee. The definition of highly-compensated employee is generally the same as that used for qualified and welfare plan purposes.[344] That is, generally the employees who are considered highly-compensated include those who (1) are or were 5% owners, (2) receive compensation in excess of $75,000, (3) receive compensation in excess of $50,000 and are in the highest-paid 20% of employees for the year, and (4) are or have been officers and receive more than 150% of the §415(c)(1)(A) amount or such year ($45,000 in 1986).[345]

If, under (4), above, an employer has no officers within the meaning of §416(i) for the year who earn the requisite threshold amount of annual compensation, §414(q)(5)(B) provides that, nonetheless, the highest paid officer shall be considered an officer for this purpose. Further, under §414(q)(5)(A), no more than 50 employees are to be counted as officers for this purpose (or, if less than 50, no more than the greater of three employees or 10% of employees). This latter rule parallels the similar rule contained in §416 for counting officers for top-heavy plan purposes. Under §414(q)(2), any employee who was in the highest 100 paid employees in the current year and fits in any of the last three categories, above, will also be treated as highly-compensated. An employee not considered highly-compensated in the previous plan year, however, will not be considered highly-compensated for the current plan year as a result of qualifying under one of these three categories unless the employee is also one of the top 100 employees by compensation. The dollar limits in the definition are indexed for inflation.

Section 414(q)(6) provides special attribution rules regarding certain family members. Under §414(q)(9), former employees will be treated as highly-compensated if the employee was highly-compensated when he or she separated from service or at any time after attaining age 55.

b. *Compensation Definition*

For purposes of measuring compensation, a new statutory definition of compensation is also made applicable.[346] This definition is the same as that generally used for qualified plan purposes.[347] In general, this definition provides that compensation includes all compensation currently includable in gross income. Salary reduction contributions under §§125, 402(a)(8), 402(h) and 403(b) may, by election, be included in compensation. Any other definition of compensation, however, will only be permitted to the extent authorized by regulations.[348]

c. *ADP Limits*

The Act §1116(a) reduces the ADP limit calculations so that the ADP of the highly-compensated employees cannot exceed 1.25 times the ADP of the nonhighly-compensated employees or, if greater, two times the ADP of the nonhighly-compensated eligible employees but not more than two percentage points greater than the ADP of the nonhighly-compensated eligible employees.[349] Under this new ADP test, the following limitations would apply:

[342] Act §1104(c)(4).
[343] Act §1116.
[344] §402(k)(5); §414(q) as added by Act §1114.
[345] §414(q).
[346] §414(s).
[347] *Id.*
[348] §414(s)(4).
[349] Amended §401(k)(3)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ADP for Non-highly Compensated	*ADP for Highly Compensated*
1	2
2	4
3	5
4	6
5	7
6	8
7	9
8	10
9	11.25
10	12.50
11	13.75
12	15

Note: The net result of the ADP limits is a reduction in the deferrals available for the highly-compensated employees.

Example: "Before the 1986 TRA, a top-paid executive in a company with a §401(k) plan could have contributed 9% of his compensation to the §401(k) plan if the ADP of the lower paid two-thirds were 6%. After the Act, however, the executive's limit will instead be 8%.

d. Treatment of Excess Contributions

One of the more significant problems in administering §401(k) plans before the Tax Reform Act of 1986, had been compliance with the ADP limits. Because the limits are applicable for a current plan year, it is often difficult for administrators to determine whether the limits are being satisfied until after the close of the plan year. As a result, the limits could be inadvertently exceeded with the possible sanction of plan disqualification for violating the requirements of §401(k).

The Tax Reform Act of 1986 addresses this problem by adding new §401(k)(8).[350] Under §401(k)(8), a §401(k) plan will not be treated as having violated the ADP limits if the excess contributions and any income allocable to those contributions is distributed before the close of the following plan year, *i.e,* the plan year following the plan year in which the excess contribution was made.[351] Alternatively, to the extent provided in regulations, the employee could elect to treat the amount of the excess contribution as an amount distributed to the employee and then contributed by the employee to the plan.[352] That is, the employee would, in effect, be able to treat the excess contribution as an after-tax contribution. Any distribution of excess contributions and income is authorized to be made without regard to any other provision of law.[353]

For purposes of these rules, "excess contribution" is defined as, for any plan year, the excess of the aggregate amount of employer contributions actually paid over to the trust on behalf of a highly compensated employee for that plan year over the maximum amount of contributions permitted under the limitations of §401(k)(3)(A)(ii) (the ADP limits).[354] The statutory provisions prescribe that in reducing excess contributions, the excess contributions of the highly-compensated employee with the highest ADP percentage are to be reduced first.[355] Distributions are to be made to highly-compensated employees on the basis of the respective portions of the excess contribution attributable to each of the employees.[356]

For purposes of taxation, however, there is no tax exemption provided for the distribution. That is, the distribution of an excess contribution would be subject to income tax in accordance with the normal rules applicable to distributions from qualified plans.[357] A special exemption is, however, provided to waive the excise tax for early distributions from qualified plans under §72(t).[358]

In addition, a 10% excise tax is imposed on the employer for the taxable year on the sum of any excess distribution under a §401(k) plan which is part of the plan for the plan year ending in the taxable year and any excess aggregate contributions under the plan for plan years ending in that taxable year.[359] Thus, failure to distribute the excess contribution in accordance with these rules will cause the employer to have to pay a 10% excise tax on the excess amount.

For purposes of calculating this tax, "excess contribution" has the same meaning as provided for purposes of §§401(k), 403(b), 408(k) and 501(c)(18).[360] The term "excess aggregate contributions" means the aggregate amount of matching contributions and employee contributions (including qualified nonelective contributions) over the maximum amount of contributions permitted in accordance with the rules of §401(m).[361] As noted above, the excise tax applies to qualified plans, annuity plans under §403(a), tax-sheltered annuities under §403(b), simplified employee pension plans under §408(k) and plans described in §501(c)(18).[362]

An exception is provided, however, if the distribution is made within 2½ months after the close of the prior year. That is, the excise tax that would have been imposed on the employer is waived if the excess contribution or the excess aggregate contribution is distributed (or forfeited) before the close of the first 2½ months following the plan year.[363]

Note: The net result is that plans are provided with more flexible sanctions but will have to continue to monitor the ADP limits very closely. Plans will apparently be able to distribute the excess contributions to the employees but will have to do so within 2½ months after the close of the year in order to avoid the excise tax, and will thereby also avoid plan qualification problems. Once regulations are issued, employees may be able to elect to have the amounts recharacterized as after-tax contributions and left in the

[350] Act §1116(c)(1).
[351] §401(k)(8)(A)(i).
[352] §401(k)(8)(A)(ii).
[353] §401(k)(8)(A).
[354] §401(k)(8)(B).
[355] *Id.*
[356] §401(k)(8)(C).
[357] *See* §§72 and 402.
[358] §401(k)(8)(D).
[359] §4979 as added by Act §1117(b).
[360] *See* §4979(c).
[361] *See* §401(m)(6)(B) as added by Act §1117(a).
[362] §4979(e).
[363] §4979(f).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

plan if that would not cause problems under the rules of §401(m).

3. Antidiscrimination Rules for Employer Matching Contributions and Employee Contributions

The 1986 TRA establishes new nondiscrimination tests for employer matching contributions and employee contributions.[364] These rules are patterned after the provisions of §401(k) although there are difficult inter-relationship problems for employers that have both §401(k) plans and plans that permit either employer matching contributions or employee contributions.

a. Nondiscrimination Tests

New §401(m) establishes a nondiscrimination test similar to the ADP test of §401(k) for any "matching contributions" or "employee contributions." These tests are established by establishing a "contribution percentage" requirement that mechanistically is like the ADP test in §401(k)(3)(A). Thus, the contribution percentage for any plan year is satisfied if the contribution percentage for the eligible highly-compensated employees does not exceed the greater of:

(1) 125% of that percentage for all other eligible employees; or

(2) the lesser of 200% of that percentage for that percentage for all other eligible employees, or that percentage for all other eligible employees plus two percentage points.[365]

Generally, two or more plans of an employer to which matching contributions, employee contributions or elective deferrals are made are treated as one plan if they are so treated for purposes of §410(b). Also, if a highly-compensated employee participates in two or more plans of an employer to which such contributions are made, all of the contributions to those plans are aggregated for purposes of this test.[366]

In order to understand the provisions of §401(m), it is necessary that the terminology be defined. Of principal importance is the term "matching contribution." As defined, it includes any employer contribution made to the plan on behalf of an employee on account of an employee contribution made by that employee and any employer contribution made to the plan on behalf of an employee on account of the employee's elective deferral.[367] As a consequence, "matching contributions" apply to both matching contributions on after-tax employee contributions and matching contributions on before-tax employer contributions.

Note that "highly-compensated employee" is also defined in the same manner as for qualified plans under §414(q).[368]

The "contribution percentage" is calculated in the same manner as the actual deferral percentage under §401(k). That is, the contribution percentage for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of the matching contributions and employee contributions paid under the plan on behalf of each employee for such plan year to the employee's compensation for that plan year.[369] The statutory provisions provide that under regulations the employer may elect to take into account in computing the contribution percentages elective deferrals and qualified nonelective contributions under the plan or any other plan of the employer.[370] For this purpose, the term "qualified nonelective contribution" means any employer contribution, other than a matching contribution, with respect to which the employee may not elect to have the contribution paid to the employee in cash instead of being contributed to the plan and the requirements of §401(k)(2)(B) and (C) are met.[371] The requirements of §401(k)(2)(B) and (C) are generally the requirements that prohibit distribution before the events specified in §401(k) and that require that the contributions be nonforfeitable when made.

For purposes of the testing, all eligible employees are included in the group tested for purposes of the contribution percentages. In addition, any employee who is eligible to make an employee contribution (or, if the employer takes elective contributions into account, elective contributions) or to receive a matching contribution under the plan being tested is to be considered an eligible employee for purposes of the plan.[372] Further, if employee contributions are required as a condition of participation in the plan, any employee who would be a plan participant if he made the necessary contribution is to be treated as an eligible employee on behalf of whom no employer contributions are made.[373]

Example: A defined contribution plan permits voluntary employee contributions to be made by any participant. If the only persons who make voluntary employee contributions are highly-compensated employees, then those employee contributions would not satisfy the test under §414(m) because all of the participants would be eligible to make contributions and would be treated as eligible employees. The plan would exceed the limitations of §401(m)(2).

b. Treatment of Excess Aggregate Contributions

Section 401(m) contains rules similar to those in §401(k) regarding the treatment of excess contributions. For purposes of §401(m), the applicable definition is "excess aggregate contributions." This term is defined as the excess for any plan year of the aggregate amount of the matching contributions and employee contributions (and any qualified nonelective contributions or elective contributions taken into account in computing the contribution percentage) actually made on behalf of highly-compensated employees for the year over the maximum amount of such contributions permitted under the limitations of

[364] Act §1117.
[365] §401(m)(2)(A).
[366] §401(m)(2)(B).
[367] §401(m)(4)(A). The term "elective deferral" is defined in the same way as in §402(g)(3)(A).
[368] §401(m)(8).
[369] §401(m)(3). The term "compensation" uses the definition in §414(s).
[370] §401(m)(3).
[371] §401(m)(4)(C).
[372] §401(m)(5)(A).
[373] §401(m)(5)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

§401(m)(2)(A).[374] Just as in the case of §401(k) plans, the maximum amount is to be determined by reducing the contributions made on behalf of highly-compensated employees in the order of their contribution percentages beginning with the highest percentage.[375] Also, any distribution of the excess aggregate contributions is to be made to the highly-compensated employees on the basis of the respective portions of the amounts attributable to each such employee. Forfeitures of excess aggregate contributions may not be allocated to participants whose contributions are reduced under the reductions for excess aggregate contributions.[376] Further, the determination of the amount of excess aggregate contributions for a plan is made after first determining the excess deferrals under §402(g) and then determining the excess contributions under §401(k).[377]

Under the rules for excess aggregate contributions, a plan is not treated as failing the requirements of §401(m) for any plan year if before the close of the following plan year the amount of the excess aggregate contributions for the year and any income allocable to those contributions is distributed or, if forfeitable, is forfeited. Those distributions may be made without regard to any other provision of law.[378]

Distributions of the excess aggregate contributions are generally taxable in accordance with the rules under §§402 and 72. However, any employee contributions, since made on an after-tax basis, are not includable in income except to the extent attributable to income on those contributions,[379] and the tax on early distributions under §72 is not applied.[380]

Finally, the tax on excess contributions under §4979 is potentially applicable to any excess aggregate contributions in the same manner as it applies for excess contributions.[381]

c. Relationship to Section 401(k) Plan

One of the more difficult aspects of applying the new rules of §401(m) is determining the relationship between §401(m) and §401(k). Many plans permit both after-tax and before-tax contributions to a single plan and many §401(k) plans will provide matching contributions for both the employee contributions and the elective contributions made by employees. As a result, a common problem will be determining the applicability of the tests under §401(k) and §401(m) to a single plan and to multiple plans of the same employer.

The statutory rules do not provide definitive answers to all of the issues involved. One question, for example, is the extent to which qualified nonelective contributions by the employer can be used to satisfy the tests under §401(k) and §401(m) and, if so, whether such contributions are used first for purposes of one test or the other. While there is no definitive answer, the inference from the statutory provision appears to be that qualified nonelective contributions and elective contributions are first used to qualify the plan under the §401(k) test and then possibly could be used to qualify the plan under the §401(m) test to the extent not used in meeting the requirements of §401(k).[382] It seems unlikely that the same dollar contribution could be used for purposes of both the tests under §401(k) and the tests under §401(m).

Another issue is raised through the delegation of authority to issue regulations to prevent the multiple use of the alternative limitation with respect to any highly-compensated employee.[383] Because the Secretary has the authority to issue these regulations, it appears probable that some type of substantive rule was intended to prevent duplicate use of this alternative limitation. For this purpose, "alternative limitation" means the limitation in §401(k)(3)(A)(iii)(II) and the limitations of §401(m)(2)(A)(ii).[384] That is, the part of the ADP and contribution percentage requirement that permits the highly-compensated employees to have a deferral up to the lesser of 200% of the percentage for the other eligible employees or that percentage for the other eligible employees plus two percentage points.

Example: An employer maintains a §401(k) plan with a 100% matching employer contribution. If the non-highly-compensated employees make elective contributions of 2% of compensation, *i.e.*, their ADP is 2%, and the eligible highly-compensated employees make elective contributions of 4% of their compensation, the ADP tests of §401(k)(3) would appear to be satisfied with respect to the elective contributions. The matching contributions, because they would be identical in percentages to the elective contributions, would also appear to satisfy the contribution percentage requirements of §401(m). However, under the regulations under §401(m)(9), the highly-compensated employees would be obtaining a "multiple use of the alternative limitation." Therefore, the plan may not satisfy the requirements of both §§401(k) and 401(m).

No clear answer appears available on the definitive application of the rules that will prohibit the multiple use of the alternative limitation. Because that limitation will be widely used, any restriction is likely to have a major impact on the design of §401(k) plans.

d. Effective Date

The general effective date rule for the provisions governing §401(m) and the new excise tax on excess contributions is for plan years beginning after December 31, 1986.[385] In the case of collectively bargained plans, however, that were ratified before March 1, 1986, the amendments of Act §1117 do not apply to plan years beginning before the earlier of:

(1) January 1, 1989; or

(2) the date on which the last such collective bargaining agreement terminates determined without regard to any extensions after February 28, 1986.

[374] §401(m)(6)(B).
[375] *Id.*
[376] §401(m)(6)(C).
[377] §401(m)(6)(D).
[378] §401(m)(6)(A).
[379] §401(m)(7)(B).
[380] §401(m)(7)(A).
[381] *See* §4979.
[382] *See* §401(m)(3).
[383] §401(m)(9)(A).
[384] §401(m)(9).
[385] Act §1117(d)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

A special date for certain annuity contracts under §403(b) is also provided. In the case of these tax-sheltered annuities, the amendments made by Act §1117 apply to plan years beginning after December 31, 1988, and in the case of collectively bargained agreements applicable to these contracts, the amendments do not apply to years beginning before the earlier of:

(1) the later of

(i) January 1, 1989; or

(ii) the date on which the last such collective bargaining agreement terminates determined without regard to extensions after February 28, 1986; or

(2) January 1, 1991.

Thus, §403(b) contracts generally have a one-year deferral of the effective date.

4. Other Changes

The 1986 TRA made a number of other changes in the rules applicable to these types of plans, especially §401(k) plans.

a. Withdrawal Restrictions

The 1986 TRA modifies the withdrawal rules applicable to §401(k) plans in part to reduce the possibility of employees making in-service withdrawals or otherwise withdrawing the allocations before termination of employment or retirement. This is accomplished in large part by the imposition of the excise tax on distributions before age 59½.[386] In addition, however, the withdrawal provisions of §401(k) are modified.

One of the results of this change in the withdrawal rules of §401(k)(2) is to limit the type of contribution that can be withdrawn as a result of hardship. The only withdrawals permitted are withdrawals of the employee's elective deferrals. Thus, amounts attributable to income on the elective deferrals, matching contributions and nonelective contributions are not withdrawable.[387]

Under the modifications, amounts held by the §401(k) plan may not be distributable to participants or other beneficiaries earlier than on one of the following specified events:

(1) separation from service, death or disability;

(2) termination of the plan without establishment of a successor plan;

(3) the date of the sale by a corporation of substantially all the assets [388] used by the corporation in the trade or business of the corporation with respect to an employee who continues employment with the corporation acquiring the assets;

(4) the date of the sale of such corporation's interest in a subsidiary [389] with respect to an employee who continues employment with such subsidiary;

(5) in the case of a profit-sharing or stock bonus plan, the attainment of age 59½; or

(6) in the case of contributions to a profit-sharing or stock bonus plan to which §402(a)(8) applies (dealing with elective contributions by employees), upon hardship of the employee.[390]

One of the principal changes incorporated into these provisions is the ability to make distributions to participants or beneficiaries on plan termination or on other events comparable to plan termination (*e.g.*, sale of substantially all of the corporate assets). While withdrawals are still permitted upon the hardship of the employee and that the definition has apparently not been changed by the Tax Reform Act of 1986, it should be kept in mind that the early distribution tax under §72(t) may effectively eliminate the interest of most employees in taking hardship withdrawals.

Note: Many commentators are concerned that the adverse tax consequences on accessing the money before age 59½ in a §401(k) plan may cause the nonhighly-compensated employees to reduce their elective contributions to the plan, thereby further restricting the deferral ability of highly-compensated employees and diminishing the usefulness of the plan as a retirement vehicle.

Note, however, that loans from §401(k) plans are still generally permitted.[391] In order for the interest on the loans to be deductible, however, the loan would have to satisfy the general rules on deductible interest as well as the special rules applicable to qualified plans.[392]

b. Service

Qualified plans are generally permitted to have a waiting period before which employees are eligible to participate in the plan based on the years of service with the employer. Under the rules of §410, that waiting period can be up to one year (with a vesting schedule) or up to three years (with 100% vesting), although the 1986 TRA will eventually reduce the three-year waiting period to a two-year waiting period.

The 1986 TRA, however, prohibited §401(k) plans from utilizing these general eligibility rules and instead, mandated that employees not be required to have more than one year of service with the employer maintaining the plan in order to participate in the CODA.[393]

Note: For those plans that have utilized a three-year waiting period with 100% vesting, the imposition of this rule may substantially increase the cost of maintaining a §401(k) plan since employees would have to be brought into the plan at a substantially earlier date.

c. Exempt Organizations

Section 401(k) expressly prohibits the adoption of qualified CODAs as part of a plan maintained by a state or local government or political subdivision thereof, or any agency or instrumentality thereof, or any organization

[386] *See* §72(t).
[387] Conf. Rep. at 389.
[388] As defined in §409(d)(2).
[389] As defined in §409(d)(3).
[390] §401(k)(2)(B).
[391] *See* §4975(d)(1).
[392] §§163 and 72(p)(3).
[393] §401(k)(2)(D).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

exempt from tax under Subtitle A of the Internal Revenue Code.[394] Thus, governmental organizations, charitable organizations, trade associations, farmers cooperatives, social clubs, labor unions and other organizations will not be permitted to maintain §401(k) plans. An exception is provided, however, for CODAs adopted by a state or local government or political subdivision thereof before May 6, 1986 or by a tax-exempt organization before July 2, 1986.[395]

d. Benefits Not Contingent on Election to Defer

An additional new rule applicable to §401(k) plans is that any benefit provided by the employer cannot be conditioned directly or indirectly on electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash.[396] This prohibition against benefits not being contingent on an election to defer is, however, not applicable to any matching contributions.[397] For example, a plan may not provide that voluntary after-tax employee contributions may not be made until an employee makes a minimum amount of elective deferrals under the plan. Further, elective deferrals cannot be used to satisfy the minimum contribution requirements for nonkey employees in a top-heavy plan.[398]

A special exception is provided for "qualified offset arrangements." A qualified offset arrangement is an arrangement with a defined benefit plan if the offset involved arrangement involved with respect to the two plans satisfies a series of requirements on April 16, 1986 and at all times thereafter:

(1) the benefits under the defined benefit plan is directly and uniformly conditioned on the initial elective deferrals up to 4% of compensation;

(2) the benefit provided under the defined benefit plan before the offset is at least 60% of the employee's cumulative elective deferrals up to 4% of compensation; and

(3) the benefit under the defined benefit plan is reduced by the benefit attributable to the employee's elective deferrals under the plan up to 4% of compensation and the income allocable thereto.[399]

5. Effective Date

Except as otherwise indicated above, the provisions applicable to §401(k) plans are effective for years beginning after December 31, 1988. However, many of the provisions, including the new ADP limits, the limits on benefits being made contingent on election deferral, the limitations on adoption by state and local governments and tax-exempt organizations, the rules on defining highly-compensated employees and compensation are applicable for years beginning after December 31, 1986. Thus, the more significant changes are actually applicable for plan years beginning after 1986.

The provisions allowing the distribution of excess contributions and the authority to issue rules allowing other types of contributions to be used in satisfying the tests of 401(k)(3) are effective for years beginning after December 31, 1986.[400] The rules allowing distribution on sale of plan assets or plan terminations generally (as found in §401(k)(2)(B)(i)(II)-(IV), apply to distributions after December 31, 1984.[401]

Also, a special effective date exists for collectively bargained arrangements ratified before March 1, 1986. These arrangements are not effected by the changes in Act §1116 before the earlier of:

(1) the later of (i) January 1, 1989 or (ii) the date on which the last collective bargaining agreement terminates determined without regard to any extensions after February 28, 1986; or

(2) January 1, 1991.[402]

Finally, if a plan amendment is required to allow a plan to make a distribution of any excess contributions under §408(k)(8), any distribution made before the close of the first plan year to which the amendment is required to be in effect in accordance with the rules of Act §1140 is to be treated as if made in accordance with the provisions of the plan.[403] Thus, plans can utilize the rules on excess contributions even if the plan has not been amended to explicitly so provide. The statutory provisions further provide that the Secretary or his delegate shall prescribe a model amendment to allow the plan to make the distributions provided in §401(k)(8) and that adoption of that amendment and a distribution in accordance with that amendment shall be treated as made in accordance with the provisions of the plan.[404]

IV. Other Qualification Rules

A. Introduction

1. Interest Rate Assumptions

The Retirement Equity Act of 1984 (REA) added provisions to the Internal Revenue Code and ERISA that preclude a plan from cashing out a participant without his consent if the present value of that participant's accrued benefit exceeds $3,500.[405] In determining the present value of the participant's accrued benefit, the statute requires that the present value is to be calculated by using an interest rate not greater than the interest rate that would be used as of the date of distribution by the Pension Benefit Guaranty Corporation (PBGC) for purposes of determining the present value of a lump-sum distribution on plan termination.[406]

In addition, REA requires that for plans subject to the requirement that a survivor benefit be provided to a surviving spouse, if the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, the spouse's

[394] §§401(k)(4)(B).
[395] Act §1116(f)(2)(B).
[396] §401(k)(4)(A).
[397] *Id.*
[398] Conf. Rep. at 390.
[399] Act §1116(f)(5).
[400] Act §1116(f)(3).
[401] Act §1116(f)(6).
[402] Act §1116(f)(4).
[403] Act §1116(f)(7)(A).
[404] Act §1116(f)(7)(B).
[405] Code §411(a)(11)(A); ERISA §203(e)(1).
[406] Code §411(a)(11)(B); ERISA §203(e)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

consent must be obtained before the plan can cash out any part of the present value in a form other than a qualified joint and survivor annuity or a qualified preretirement survivor annuity.[407] The applicable interest rate used for this purpose is calculated in the same manner.[408]

After the enactment of these provisions but before regulations were issued, some commentators felt that the interest rate requirements for determining the present value of the accrued benefit were only applied for purposes of determining whether the present value of the accrued benefit exceeded $3,500. That is, they felt that the provisions did not prohibit a plan from continuing to use its own interest rate in otherwise valuing accrued benefits. The regulations, however, took a broader view of these requirements and provided that, in valuing accrued benefits, the PBGC interest rate was to apply so that the present value of the nonforfeitable accrued benefit must be determined using an interest rate not greater than the PBGC rate to value immediate annuities for a plan terminating as of the distribution date or as of the first day of the plan year that contains the distribution date.[409] Further, the regulations took the position that any change in the interest rate is subject to the anti-cutback rules of Code §411(d)(6).[410] The effective date of these regulations provided that they were not applicable to contracts distributed or owned by a participant before September 17, 1985, unless additional contributions are made under the plan by the employer with respect to those contracts.[411]

2. Profits Required

One of the fundamental requirements for profit-sharing plans has been that contributions can only be made out of current or accumulated profits.[412] Contributions to profit-sharing plans may, however, be discretionary so that the employer may decide from year to year whether to make contributions to the plan. Because of the requirement of profits, however, some uncertainty has existed concerning whether it is permissible for tax-exempt employers to maintain a profit-sharing plan, since such employers are not normally considered to have profits.

3. Benefit Forfeitures

Under the vesting rules applicable to qualified plans, a participant who terminates employment when his accrued benefit or account is not fully vested will generally be subject to a forfeiture of the nonvested portion of that accrued benefit or account. In the case of profit-sharing plans, these forfeitures are either reallocated among the remaining participants or used to reduce the employer's contribution obligation in succeeding years. In defined benefit plans, however, forfeitures must be used to reduce future employer contributions.[413]

Before the Tax Reform Act of 1986, money purchase pension plans were required to follow the rule for defined benefit plans. That is, the forfeitures were required to be used to reduce succeeding years' employer contributions.

4. Bona Fide Collective Bargaining Agreements

Under the rules applicable to pension plans, a number of special provisions apply if the plan is maintained pursuant to a collective bargaining agreement. For example, employees may be excluded from eligibility to participate in a plan if they are covered by a collective bargaining agreement and if there was evidence that retirement benefits were the subject of good faith bargaining between the employer and employee representatives.[414] In addition, effective date rules are often delayed with respect to plans maintained pursuant to collective bargaining agreements. Before the 1986 TRA, there was no clear definition of a collective bargaining agreement in the law.[415]

5. Ratable Accrual of Benefits for Top-Heavy Purposes

Code §416 imposes requirements for qualified plans that are top-heavy. If the plan's accrued benefits are primarily (60% or more) for the benefit of key employees, the plan is considered top-heavy. Top-heavy plans are subject to faster vesting requirements, minimum contribution requirements and limits on the amount of compensation that may be taken into account.[416]

A defined benefit plan is top-heavy if the present value of the cumulative accrued benefits for key employees exceeds 60% of the present value of the cumulative accrued benefits for all employees under the plan.[417] Defined benefit plans must satisfy one of three accrual rules in Code §411 to maintain their qualified status.[418] The purpose of these accrual requirements is to prevent plans from postponing accruals (backloading benefit accruals) to circumvent the vesting and benefit requirements for qualified plans. Some of the permitted methods under §411, however, permit a degree of backloading.[419] Under pre-TRA law, plans may qualify by satisfying any of the three accrual rules of §411(b).

6. REA Exception

REA required pension plans to provide survivor benefits generally to certain married participants who retire under the plan (with payment in the form of a qualified joint and survivor annuity) and to surviving spouses of vested participants who die before their annuity starting date (with payment in the form of a qualified preretirement survivor annuity).[420] A transition rule was provided for participants who separated from service before REA's enactment date if their benefits were not in pay status as of that date (August 23, 1984). This provision applies to participants who complete at least one hour of service under the plan after December 1, 1974, and separate from service before the first day of the plan year beginning on or after January 1, 1976 where the plan is otherwise required

[407] Code §417(e)(1) and (2); ERISA §205(g)(1) and (2).
[408] Code §417(e)(3); ERISA §205(g)(3).
[409] Temp. Regs. §1.417(e)-1T(e)(1).
[410] Temp. Regs. §1.417(e)-1T(e)(2).
[411] Temp. Regs. §1.417(e)-1T(f)(2).
[412] Regs. §1.401-1(b)(1)(ii).
[413] §401(a)(8). *See also* Conf. Rep., p. II-442.
[414] *See* §410(b)(3).
[415] Conf. Rep. at 486.
[416] *See* §416.
[417] §416(g).
[418] §411(b).
[419] §411(b).
[420] *See* §§401(a)(11) and 417.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(*i.e.*, under pre-REA law) to provide a joint and survivor annuity. Under this transition rule, the participant is to be given the right to elect to receive benefits in the form of a qualified joint and survivor annuity.[421]

B. Overview

1. Interest Rate Assumptions

The 1986 TRA amended the interest rate assumption requirements for determining the present value of an accrued benefit. If the present value of the accrued benefit does not exceed $25,000, the amount to be distributed to the participant or beneficiary is calculated using the applicable PBGC rate. If the present value exceeds $25,000, however, the amount to be distributed is calculated using an interest rate no greater than 120% of the interest rate that would be used by the PBGC for that type of distribution. The distribution, however, cannot be reduced below $25,000 by using this higher interest rate.

2. Elimination of Profits Requirement

The 1986 TRA eliminated the requirement for profit sharing plans that contributions must be made from current or accumulated profits. Thus, sponsors of profit-sharing plans, like money purchase pension plans, may make contributions regardless of whether they are profitable and regardless of whether the employer is a tax-exempt organization.

3. Benefit Forfeitures

The 1986 TRA permits forfeitures in money purchase pension plans to be reallocated among participants or to be used to reduce employer contributions in succeeding years. Thus, forfeitures in a money purchase pension plan may be treated in the same way as forfeitures under a profit-sharing plan.

4. Bona Fide Collective Bargaining Agreements

The 1986 TRA makes it clear that any collective bargaining agreement will not be recognized for qualified plan purposes unless it is a bona fide agreement between employee representatives and employers.

5. Ratable Accrual for Top-Heavy Purposes

The 1986 TRA eliminated most of the flexibility in defined benefit plans in selecting an accrual method for purposes of determining whether the plan is top-heavy. For this purpose, defined benefit plans must generally use the fractional method of accrual, which avoids any backloading of benefits. Plans will, however, be free to continue to satisfy any of the three accrual rules for other purposes.

6. Exception From REA Provisions

The Act provides an exception from the survivor benefit requirements of REA for certain plans established before 1954 under which participation is substantially limited to people who retired before January 1, 1976.

C. Detailed Analysis

1. Interest Rate Assumptions

The Tax Reform Act of 1986 changes the method to be used by defined benefit plans in calculating the present value of a participant's accrued benefit.[422] Under these provisions, the present value of a participant's or beneficiary's accrued benefit is calculated in two parts; first, by using an interest rate no greater than the applicable interest rate in the case of a vested accrued benefit that does not exceed $25,000, and second, by using an interest rate no greater than 120% of the applicable interest rate if the vested accrued benefit exceeds $25,000, as determined under the first step outlined above. In no event, however, may the present value determined under the second step be less than $25,000.

For this purpose, the "applicable interest rate" is the interest rate that would be used as of the date of distribution by the PBGC for purposes of determining the present value of a lump-sum distribution on plan termination.[423] These rules apply both for purposes of calculating the present value of the interest rate for purposes of the cash-out rules in §411(a)(11) and for purposes of the consent rules in §417(e). Under these provisions, if a participant's total accrued benefit using the applicable PBGC rate is $50,000, the 1986 TRA would permit the plan to use 120% of the applicable PBGC rate, potentially making the participant's total accrued benefit $47,000 instead of $50,000.[424]

Note: The Conference Report indicates that Congress recognized that the PBGC is considering adopting new methods and interest rate structures for valuing accrued benefits on plan termination. If these methods and structures are adopted, the Treasury Secretary is to provide timely guidance regarding these methods under the provisions of the 1986 TRA.

The PBGC rate in effect at the beginning of the plan year may be used throughout the plan year if the plan so provides.[425]

These amendments apply generally to distributions in plan years beginning after 1984, except that they do not apply to distributions in plan years beginning after 1984 and before 1987 if the distributions were made in accordance with the requirements of the regulations issued under REA.[426] The adoption of a plan amendment before the close of the first plan year beginning on or before January 1, 1989 which provides for the calculation of the present value of accrued benefits in accordance with the 1986 TRA is not treated as a violation of Code §411(d)(6) (or ERISA §204(g))[427] if the plan reduces the accrued benefit for any plan year to which the amendment applies in accordance with the 1986 TRA.[428]

The effective date rules for this provision are particularly confusing. In general, the provisions apply retroactively for plan years beginning after 1984. Plans that have already made distributions in 1985 or 1986, however, are generally exempt from applying the 1986 TRA provisions

[421] REA §303.

[422] Act §1139.

[423] Code §§411(a)(11)(B)(ii) and 417(e)(3)(B); ERISA §§203(e)(2) and 205(g)(3).

[424] Conf. Rep. at 488.

[425] *Id.*

[426] Act §1139(d)(1).

[427] The anti-cutback rule.

[428] Act §1139(d)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

to those distributions as long as the distributions were made in accordance with the REA regulations. The REA regulations were not effective for certain contracts distributed before September 17, 1985. In some cases, plans may have also made distributions during this interval (*i.e.*, before the REA regulations were issued) that are neither grandfathered, nor in compliance with the regulations. Thus, some plans may have made distributions between January 1, 1985 and September 17, 1985 that were not in compliance with the REA regulations and therefore are potentially subject to having the effective date rules of the 1986 TRA provisions applied retroactively to 1984.

A special exception is also made in these rules for certain plans maintained by corporations incorporated on April 11, 1934 that are headquartered in Tarrant County, Texas.[429]

2. Profits Not Required

The 1986 TRA added Code §401(a)(27), eliminating the requirement that profit- sharing contributions must be made from profits.[430] Under §401(a)(27), the determination of whether a plan under which contributions are made is a profit-sharing plan is made without regard to current or accumulated profits of the employer and without regard to whether the employer is a tax-exempt organization.

Thus, nonprofitable employers will be permitted, after making appropriate plan amendments, to contribute to profit-sharing plans even though they do not have the profits from which to make the contributions. The statute, however, would not appear to require any such contribution so that, if an employer chose to limit its contributions to profits, it appears that it may continue to do so. An existing profit-sharing plan that has such a profits limit will thus continue to operate in this fashion until an amendment deleting the profit requirement is made.

In addition, tax-exempt employers may maintain profit sharing plans without concern that the type of plan is inappropriate under the applicable provisions of law. This removes any doubt about the suitability of §401(k) cash or deferred profit-sharing plans for tax-exempt employers although, with some exceptions, after the 1986 TRA, tax-exempt organizations are no longer eligible to establish §401(k) plans.[431] While this provision may resolve any question about the viability of a profit-sharing plan for a tax-exempt organization from the perspective of the pension rules, such a plan would still only be suitable for a tax-exempt organization if it is acceptable under the exempt organization requirements applicable to that employer. For example, a §501(c)(3) organization would want to be certain that adoption of a profit-sharing plan was not considered to be the inurement of profit in violation of §501(c)(3).

The Secretary may require defined contribution plans to specify whether they are pension plans or discretionary contribution plans.[432]

These provisions are retroactively effective and apply to years beginning after 1985.[433]

3. Benefit Forfeitures

The 1986 TRA modified the provisions on benefit forfeitures to effectively allow money purchase pension plans to reallocate forfeitures among remaining plan participants.[434] This is accomplished by modifying §401(a)(8) to change the requirement for pension plans that forfeitures must not be applied to increase the benefits that any employee would otherwise receive under the plan. As modified by the 1986 TRA, §401(a)(8) only applies to defined benefit plans. Since money purchase pension plans are defined contribution plans, they would be exempt from the requirement and free to reallocate forfeitures among remaining participants. Whether such a forfeiture reallocation provision is utilized will be a question of plan design and until changed, existing money purchase plans will presumably continue to use forfeitures to reduce employer contributions in succeeding years.

These provisions apply to plan years beginning after 1985.

4. Bona Fide Collective Bargaining Agreements

The 1986 TRA modified the definition of "collective bargaining agreements" in the Internal Revenue Code to make it clear that the agreements must be bona fide.[435] This is accomplished by a modification of §7701(a)(46) to add a sentence providing that that the agreement shall not be treated as a collective bargaining agreement unless it is a bona fide agreement between employee representatives and one or more employers.

The apparent intention of this provision is to give the IRS authority to disregard collective bargaining arrangements established on a "friendly" basis that have no substantive validity.

This provision does not contain an explicit effective date. The Conference Report indicates that the provision is a clarification of pre-1986 TRA law and is therefore intended to be given retroactive effect where appropriate.[436]

5. Ratable Accrual of Benefits for Top-Heavy Purposes

The 1986 TRA established rules for determining the accrual method to be used in calculating whether a defined benefit plan is top-heavy.[437] These accrual rules specify that, for purposes of determining whether a plan is top-heavy, the accrued benefit of an employee other than a key employee is determined under the method used for accrual purposes of all plans of the employer or, if there is no method that meets that requirement, then not more rapidly than the slowest accrual rate permitted under the fractional rule of Code §411(b)(1)(C).[438]

These provisions largely prevent an employer from selecting a special accrual method for purposes of determin-

[429] Act §1139(d)(2)(B).
[430] Act §1136.
[431] *See* Code §401(k)(4)(B).
[432] Conf. Rep. p. II-485.
[433] Act §1136(c).
[434] Act §1119.
[435] Act §1137.
[436] Conf. Rep. at 486.
[437] Act §1118.
[438] Code §416(g)(4).

ing whether the plan is top-heavy to avoid the application of the top-heavy rules. The employer can use the same method being used by the plan (if that is the only plan of the employer) or the method used for all the defined benefit plans of the employer if there is a uniform method. In the absence of such a method, however, the employer must use the fractional method, which essentially requires that benefits be accrued on a straight-line basis over the working life of the employee.

The effective date of these rules is for plan years beginning after 1986.

6. REA Special Exception

The 1986 TRA provides an exception from the survivor benefit requirements of REA for certain plans.[439] This exception is available to plans described in §404(c) in which participation is substantially limited to individuals who, before January 1, 1976, ceased employment covered by the plan.[440] Section 404(c) is generally applicable to plans established before January 1954 that were, pursuant to an agreement between employee representatives and the federal government, operated under seizure powers of a major part of the productive facilities of the industry.

The provision also exempts from the requirements of REA §301 any defined benefit plan that is terminated pursuant to a resolution directing the termination of such plan which was adopted by the board of directors of a corporation on July 24, 1984 and that occurred on November 30, 1984.[441]

These provisions are retroactively effective as if included in REA. Act §1145(d).

V. Miscellaneous

A. Penalty for Overstatement of Pension Liabilities

1. Pre-1986 TRA Law

Under pre-1986 TRA law, an employer is allowed to deduct contributions (within limits) to a trust or annuity contracts used to fund a qualified plan.[442] If the Service determines that the assumptions used to calculate employer liabilities under a defined benefit plan are unreasonable, the limit on employer deductions must be recalculated using reasonable assumptions and the excess deduction is disallowed. There is no specific penalty for overstatement of employer liability under a defined benefit pension plan, however.

The conference agreement recognizes that overstatement of pension liabilities takes place primarily in small professional corporations and involves the use of unreasonable actuarial assumptions with respect to defined benefit pension plans.[443]

2. 1986 TRA Provisions

Section 1138 of the 1986 TRA enacts Code §6659A, which imposes a penalty on the employer for overstatement of deductions for pension liabilities. The penalty takes the form of a graduated addition to tax, to be assessed, collected, and paid as a tax that applies only to an income tax underpayment attributable to the overstatement.

The amount of the underpayment of tax is the excess of the employer's actual tax liability (resulting from a proper valuation of deductions) over the actual tax liability as reduced by the valuation overstatement. If the valuation claimed exceeds from 150 to 200% of the correct valuation, the addition to tax is 10% of the underpayment. If the claim exceeds the correct amount by more than 200 but not more than 250%, the addition to tax is 20%, and if the claim exceeds the correct valuation by more than 250%, the addition to tax is 30%. The penalty is subject to a de minimis rule for valuation overstatements under $1,000. The Secretary has discretionary authority to waive the penalty if the employer can demonstrate a reasonable basis for the deduction claimed and shows that the claim was made in good faith. The employer's reliance on an enrolled actuary or other professional, however, does not constitute such reasonable basis or good faith. The conference agreement reflects the expectation that the Service will assess the penalty not only in the case of unreasonable actuarial assumptions but also when employers use methods that accelerate deductions with respect to a plan.[444]

The provision applies to overstatements occurring after the date of enactment (October 22, 1986).

B. Treatment of Certain Fishermen as Self-Employed

1. Pre-1986 TRA Law

Code §§3121(b)(20) and 3306(c)(20) make an exception to the usual rules for determining an employer-employee relationship for members of fishing boat crews.

Under that exception, the fishermen are treated as self employed for purposes of employment taxes. The Service has determined, however, that, for purposes of determining whether a pension, profit-sharing, or stock bonus plan maintained by the owner or operator of the fishing boats is a qualified plan under §401(a), the fishermen are to be treated as employees.

2. New Provision

Section 1143 of the Act added Code §401(c)(6) to provide that, for purposes of the rules relating to qualified plans, members of fishing-boat crews are treated as self-employed individuals. The provision is effective for taxable years beginning after 1986.

C. Tax Treatment of Federal Thrift Savings Fund

1. Pre-1986 TRA Law

Beginning in 1987, federal employees are allowed to contribute up to 10% of their basic pay to the Thrift Savings Plan (the "Plan") maintained by the federal government. Such contributions will not be includible in the employee's income for the year of contribution but will be includible in income upon distribution from the Plan. Act §1147 provides rules governing the tax treatment of contributions to the Plan.[445]

[439] Act §1145.
[440] Code §401(a)(11)(E); ERISA §205(b)(3) and REA §303(f).
[441] Act §1145(c), adding REA §303(f).
[442] Code §§419(e) and 162.
[443] Conf. Rep., p. II-492.
[444] *Id.*
[445] Conf. Rep., p. II-497.

2. 1986 TRA Provision

The Act added Code §7701(j), providing that employee contributions to the Thrift Savings Fund are treated as contributions to a trust (as described in §401(a)) exempt from tax (under §501(a)). Even though the employee had an election to receive the amounts in cash, the employee's contributions to the Plan are not treated as constructively received. Thus, the amounts deferred are not includible in the employee's income until distributed.

The provision is effective on the 1986 TRAs enactment date (October 22, 1986) for the program scheduled to begin January 1, 1987.

VI. Leased Employees

A. Introduction

Under the rules applicable to qualified retirement plans, employees are generally eligible to participate in any qualified plan maintained by the employer after a prescribed period.[446] The Code requires, however, that in some cases a leased employee, *i.e.*, an employee employed by another entity whose services are leased to the employer, will be treated as an employee of the recipient employer, *i.e.*, the employer utilizing the services of the employee, for purposes of the qualified plans rules. Generally, a leased employee is any person who is not an employee of the recipient organization who satisfies certain specified requirements. These include the requirement that the services be provided under an agreement between the recipient and the leasing organization.[447] In addition, the individual must have performed these services for the recipient organization on a substantially full-time basis for at least one year.[448] Finally, the services must be of a type historically performed in the business field of the recipient by employees.[449]

A leased employee who satisfies these requirements is treated as an employee after the close of the one-year period set forth in §414(n)(2)(B), except that years of service under the plan include the prior period for which the leased employee performed those services. Thus, the leased employee would not have to be treated by the recipient organization as an employee until the one-year period was satisfied but, once it was satisfied, all prior service would have to be taken into account.

Under a safe harbor,[450] a leased employee was not treated as an employee of the recipient organization if two requirements were satisfied. First, the leasing organization had to provide a money purchase pension plan with a nonintegrated employer contribution rate of at least 7½%. Second, the plan had to provide for immediate participation and full and immediate vesting.[451]

B. Overview

The Tax Reform Act of 1986 revised the leased employee rules to make it more difficult for recipient organizations to avoid treating leased employees as employees for purposes of pension and welfare plan coverage.[452] Previously the leased employee rules only applied to pension plan coverage. The TRA change results primarily from two modifications to the safe harbor rules. First, the requirements for plan coverage by the leasing organization were increased to require that the contribution rate for the money purchase pension plan maintained by the leasing organization be at least 10% of compensation. Second, to utilize the safe harbor exception, the leased employees may not constitute more than 20% of the recipient organization's nonhighly-compensated work force. Several other exceptions and special rules were provided. The other rules are generally effective on a retroactive basis, whereas the changes to the safe harbor provisions are effective for services performed after 1986.

C. Detailed Analysis

1. Safe Harbor Provisions

To qualify for the safe harbor exception, two requirements are established. First, the leased employee must be covered by a plan of the leasing organization that meets certain requirements. Second, leased employees must not constitute more than 20% of the recipient organization's nonhighly-compensated work force.[453]

a. Plan Requirements

As a result of the Tax Reform Act of 1986, the plan requirements that must be satisfied to meet the safe harbor exception of §414(n) are three-fold. First, the leased employee must be covered by a plan of the leasing organization that is a money purchase pension plan with a nonintegrated contribution rate for each participant of at least 10% of compensation. Second, the plan must provide for full and immediate vesting. Third, each employee of the leasing organization must immediately participate in the plan. This last requirement, however, does not apply to an individual whose compensation from the leasing organization in each plan year during the four-year period ending with the plan year in question is less than $1,000.

The principal 1986 TRA change in this area is the increase in the safe harbor contribution rate from 7½% to 10% of compensation. This will make it more expensive for leasing organizations to utilize the safe harbor rule.[454]

For purposes of these rules, compensation is defined in the same manner as under §415 with three modifications. First, employer contributions are included in compensation if they are not included in gross income by reason of §402(a)(8) or §402(h)(1)(B) (which deal with elective contributions to §401(k) plans and salary reduction contributions to simplified employee pension plans under §408(k)).[455] Second, compensation includes any amount the employee would have received in cash but for an election under a cafeteria plan under §125.[456] Third, compensation

[446] *See* §§401-416.
[447] §414(n)(2)(A).
[448] §414(n)(2)(B).
[449] §414(n)(2)(C).
[450] §414(n)(5).
[451] *Id.*
[452] Act §1146.
[453] §414(n)(5)(A).
[454] §414(n)(5)(B).
[455] §414(n)(5)(C)(iii)(I).
[456] §414(n)(5)(C)(iii)(II).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

includes any amount contributed to an annuity contract under §403(b) under a salary reduction agreement.[457]

b. Twenty Percent of Nonhighly Compensated Work Force

The second requirement is that leased employees, determined without regard to §414(n)(5)(A), not constitute more than 20% of the recipient's nonhighly-compensated work force. In determining the recipient organization's nonhighly-compensated work force, employees who are highly-compensated are determined by reference to the statutory definition of highly compensated employee added by the Act.[458] The nonhighly-compensated work force is the aggregate number of individuals other than highly-compensated employees, who are employees of the recipient (excluding any leased employees) who have performed services for the recipient [459] (or the recipient and related persons) on a substantially full-time basis for a period of at least one year, or who are leased employees with respect to the recipient organization (determined without regard to this paragraph).[460]

Thus, in computing the nonhighly-compensated work force, all leased employees who are treated as employees and all other employees who have been working on a substantially full-time basis for at least a year are to be included, if they are not highly-compensated.

2. Applicability of Employee Leasing Requirements

Once a leased employee is determined to be an employee for purposes of §414(n), it is important to determine the purposes for which the individual will be treated as an employee. Before the Tax Reform Act, the requirements of §414(n) essentially extended only to the requirements for qualified plans and simplified employee pension plans. The Tax Reform Act, however, extended these requirements to most of the welfare plan rules that are subject to nondiscrimination requirements. Thus, the leased employee rules apply to the nondiscrimination rules for group-term life insurance under §79; the rules for nondiscriminatory welfare plans under §89; the special rule for exclusion of employer contributions to accident or health plans under §106; the rules relating to qualified tuition reduction plans under §117(d); the rules relating to group legal service plans under §120; the rules relating to cafeteria plans under §125; the rules relating to educational assistance under §127; the rules relating to dependent care under §129; the rules on certain fringe benefits under §132; the rules on employee achievement awards under §274(j); and the rules for employee beneficiary associations and other arrangements covered by §505.[461] These provisions substantially broaden the scope and importance of the leasing rules.

3. Years of Service

Before the Tax Reform Act, the employee leasing rules generally only applied after the leased employee had been a leased employee for a year but, once a leased employee was treated as an employee, the requirements retroactively required the inclusion of service. This requirement is essentially continued after the Tax Reform Act of 1986 except that the requirement that the employee be a leased employee on a substantially full-time basis for a period of one year is reduced to six months in the case of core health benefits. Thus, in the case of an employer that has a health plan that provides for basic health coverage, a leased employee covered by §414(n) would have to be treated as an employee for purposes of the §89 rules (when they become effective) after six months instead of one year.[462]

4. Recordkeeping Requirement

The Tax Reform Act of 1986 provides the Secretary of Treasury with the authority to develope regulations under §414(n) to minimize the recordkeeping requirements of §414(n) for certain employers. The employers that would be subject to these reduced recordkeeping requirements would be employers that do not have top-heavy plans and that use the services of persons other than employees for an insignificant percentage of the employer's total work load.[463] The Conference Report indicates that the recordkeeping rule would be applied for employers with respect to which the number of individuals performing substantial services as nonemployees is less than 5% of the number of nonhighly-compensated employees performing substantial services.[464] The Conference Report further states that an individual is to be treated as having performed substantial services as a nonemployee only if the individual has at least 1,500 hours of service and that the Secretary is to prescribe rules to minimize the recordkeeping necessary to determine if the 5% test has been satisfied.[465]

5. Effective Date

The 1986 TRA employee leasing rules are generally effective for taxable years beginning after 1983. The safe harbor rules, however, are effective for services performed after 1986. The recordkeeping authority under §414(o), if applied to years beginning before the date of enactment of the Tax Reform Act, is to be applied without regard to the requirement that an insignificant percentage of the work load be performed by persons other than employees.[466]

VII. Qualification Procedures

A. Introduction

1. Pre-Act Law

Generally, plans must be adopted during the year in which they are effective and plan amendments must likewise be adopted before the close of the plan year in which they are effective.[467] If a plan amendment arises from a "disqualifying provision," the period for making the plan amendment is extended throughout the "remedial amendment period." [468] A "disqualifying provision" generally

[457] §414(n)(5)(C)(iii)(III).
[458] *See* Code §414(a).
[459] For purposes of determining related persons, the definition in §103(b)(6)(C) applies. §414(n)(6)(A).
[460] §414(n)(5)(C)(ii).
[461] *See* §414(n)(3).
[462] *See* §414(n)(4) and §414(n)(2)(B).
[463] §414(o).
[464] Conf. Rep., p. II-496.
[465] *Id.*
[466] Act §1146(c).
[467] *See* Regs. §1.401(b)-1(a).
[468] Regs. §1.401(b)-1.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

means a provision, or the absence of a provision from a plan or the amendment of a plan, that causes the plan to fail to satisfy the qualification requirements of the Code on the date the plan or amendment is made effective. A disqualifying provision also includes changes in the requirements enacted by ERISA or TEFRA. No other statutory changes have, however, been included within the parameters of a disqualifying provision.[469] The "remedial amendment period" is the period that generally begins when the plan or amendment is adopted or put into effect and ends at the time prescribed by law (including extensions) for filing the employer's income tax return for the taxable year in which the remedial amendment period began. The remedial amendment period is further extended for certain specified reasons, such as requesting an IRS determination letter on the plan or amendment.[470]

Note: Since changes made by the Tax Reform Act of 1986 are not within the definition of disqualifying provisions under the regulations, those changes would not be sufficient to allow plans to delay the adoption of amendments during the remedial amendment period. Instead, plans would generally be required to adopt the necessary amendments during the year in which the statutory changes were effective.

The IRS maintains a special procedure to enable small employers to more readily adopt qualified plans. Under the procedure for master and prototype plans, sponsors may obtain opinion letters on either a master plan (which includes both a plan and trust) or a prototype plan (which includes only a plan) and thereby ease the requirements for approval by the individual employer. This program has been popular with small employers because it minimizes the cost of adopting qualified plans and provides a more streamlined procedure for obtaining IRS approval of the plans as adopted. In the past, however, the has refused to allow sponsors to provide master or prototype plans under §401(k).[471] The Service apparently felt that the variables involved in §401(k) plans were such that it would be difficult to pre-approve the format of the plan and assure that the plan would meet all of the requirements of §401(k).

2. Reasons for Change

Existing qualified plans have, as a result of various tax law changes, been required to make numerous amendments in recent years. Changes have recently been required as a result of REA, the 1984 TRA, TEFRA, and other laws as well as a result of IRS regulatory changes. Because of the frequency with which amendments have been required and because of the desire to minimize the administrative burden and cost on plans, the 1986 TRA, recognizing that plan amendments would be required to many existing plans, provided a delayed procedure for amendments to allow all necessary amendments to be made at one time. Further, Congress tried to ensure that the necessary guidance would be available to plans to make proper amendments by mandating that the required regulations be issued before the date on which the amendments have to be made.

In addition, Congress felt that master and prototype plans should include §401(k) provisions. Congress was concerned that small employers were being denied an opportunity to utilize such plans because of the substantial cost involved in adopting and obtaining approval for individually designed plans.

B. Overview

The 1986 TRA altered the qualification procedures applicable to qualified plans to provide an extension, until the first plan year beginning after 1988, for making all of the amendments required by the Act. A condition of this extension is, however, that the plan operate in accordance with the applicable rules in the interim period and that the amendment be made effective retroactively for the required period. The Service is to develop and publish model amendments, which are to be available to plans for this interim period. The Act also requires that regulations be issued by February 1, 1988 in a number of specified areas critical to plan qualification. Finally, the Service is required to begin, no later than May 1, 1987, to accept applications for opinion letters on master and prototype plans under §401(k).

C. Detailed Analysis

1. Time for Making Plan Amendments

The Act extends the period for making amendments to qualified plans to keep them in compliance with the requirements of the Code.[472] This extension is made in a manner different from that provided for ERISA and TEFRA. That is, there is no extension of the remedial amendment period under §401(b). Instead, a non-Code provision provides an extension of the statutory requirements for amending plans.

Under this provision, any amendments required by reason of either Subtitle A (dealing with the general qualification rules for qualified plans) or Subtitle C (dealing with the requirements for ESOPs generally) of Title XI of the Act are not required to be made before the first plan year beginning on or after January 1, 1989. To have this extended period available, however, the plan must be operated during the period from effective date of the amendment to the plan year in which it is adopted in accordance with the requirements of the amendment (or in accordance with the requirements of an amendment prescribed by the Service and adopted by the plan) and the amendment, when adopted, must apply retroactively for this period.

The Act provides that a pension plan shall not be treated as failing to provide "definitely determinable benefits" or contributions or to be operated in accordance with the provisions of the plan merely because it utilizes the delayed amendment provisions.[473]

Note: The Act does not amend Title I of ERISA. Consequently, the fiduciary requirement of §404 of ERISA, as well as the other rules of Title I, are not subject to this delay. As a result, a plan that attempts to operate in accordance with rules that are not contained in the plan

[469] Regs. §1.401(b)-1(b).
[470] Regs. §1.401(b)-1(c) and (d).
[471] Rev. Proc. 84-23, §8.033, 1984-1 C.B. 457.
[472] Act §1140.
[473] Act §1140(a).

document may conceivably be faced with a legal challenge by a participant claiming benefits in accordance with the plan document as it then exists.

A further delay of the time for making the amendment is provided to plans maintained pursuant to one or more collective bargaining agreements. This delay is, however, only available if the employers ratified the agreement before March 1, 1986. In that event, instead of having to make the required plan amendment for the first plan year beginning on or after January 1, 1989, the amendment would have to be made by the first plan year beginning after the earlier of:

(1) the later of:

(a) January 1, 1989; or

(b) the date on which the last of the collective bargaining agreements terminate, determined without regard to any extensions after February 28, 1986, or;

(2) January 1, 1991.

These rules may provide even greater delay for collectively bargained plans.[474]

2. Model Amendment

The Act also requires the Service to prescribe amendments that allow a plan to meet the requirements of Subtitle A or Subtitle C of Title XI of the Act to the extent the amendments are required to be effective before the first plan year beginning after 1988.[475] That is, the Service must provide model amendments that can be adopted by plans for this interim period. The IRS published model amendments pursuant to §1140(b) of the 1986 TRA in Notice 87-2.

The Act provides that adoption of one of these model amendments and operation by the plan in accordance with the amendment automatically protects the plan against being treated as failing to provide definitely determinable benefits or contributions or failure to be operated in accordance with the plan provisions by reason of the adoption of such amendment and operation in accordance with its terms.

The Conference Report clarifies that the model amendment is to address only those amendments that are required to be made to maintain qualification for the period ending with the first plan year beginning after 1988.[476]

3. Required Date for Regulations

The Act requires that the Secretary to issue certain final regulations before February 1, 1988.[477] These regulations include regulations relating to:

(1) the nondiscrimination rules for integrated plans under Act §1111;

(2) the coverage requirements for qualified plans under Act §1112;

(3) minimum vesting standards under Act §1113;

(4) the definition of highly-compensated employee under Act §1114;

(5) separate lines of business and the definition of compensation under Act §1115;

(6) the rules for §401(k) plans under Act §1116;

(7) the nondiscrimination requirement for employer matching and employer contributions under Act §1117;

(8) the nondiscrimination requirements for tax-sheltered annuities under Act §1120; and

(9) the tax on excess distributions under Act §1133.[478]

These provisions seek to insure that the Service will issue the major qualification rules established by the Act in time to permit employers to properly respond to those requirements and make the necessary plan amendments. Note, however, that there is no penalty imposed on the government for failure to comply with this requirement and no additional delay is provided for making the amendments if the Service does not meet the required date for final regulations.

4. Master and Prototype Section 401(k) Plans

The Act requires the Secretary to begin accepting applications for opinion letters regarding master and prototype plans for qualified cash or deferred arrangements under §401(k). The Act requires that these applications be accepted not later than May 1, 1987.[479] This is designed to provide opportunities for smaller employers to adopt these plans at less cost.[480] Note, however, that the Act also permits simplified employee pension plans to adopt §401(k)-type features and thus, the availability of the master and prototype plan for §401(k) to smaller employers may be somewhat duplicative.[481] Further, the Service, in permitting master and prototype plans to be available under §401(k), probably will be highly restrictive in the options available. Because master and prototype plans are designed to be pre-approved plans that will probably automatically qualify when adopted by a particular employer, it will be difficult for the Service to approve master and prototype plans that permit the full range of variation allowed under §401(k). As a result, the Service may, as part of its master an prototype plan program, approve master and prototype §401(k) plans, but restrict the choices available in ways that will make the master and prototype plan models less desirable than those available for individually-designed arrangements.

VIII. Taxation of Employer Contributions and Tax on Nondeductible Contributions

A. Introduction

Code §404 provides, in general, that employer contributions to qualified plans are deductible in the year for which

[474] Act §1140(c).
[475] Act §1140(b).
[476] Conf. Rep., p. II-491.
[477] Act §1141.
[478] *Id.*
[479] Act §1142.
[480] *See* colloquy between Senators Baucus and Packwood, Congressional Record, S13959-13960, September 27, 1986.
[481] Act §1108.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the contributions are paid provided the contribution is an ordinary and necessary business expense or an expense for the production of income.[482] Section 404 provides deduction limits on the amount of deductible contribution an employer can make to any one plan or a combination of plans. The amount of the limit depends on the type of plan to which the contribution is made and whether an employee is covered by more than one plan of the employer. Where contributions to a plan exceed the deduction limits, the excess, in general, may be deducted in succeeding years as a carryover, provided certain numerical tests are satisfied and the contributions and the benefits which the contributions are funding do not exceed the overall limits on contributions or benefits set forth in Code §415.[483]

Specifically, Code §404(a)(3) permits a deduction for contributions to qualified profit sharing and stock bonus plans, provided the contribution does not exceed 15% of the aggregate compensation of all employees that are covered by the plan for the year in which the contribution is made. If the employer's contributions exceed the deduction limits, §404(a)(3) permits the excess to be carried over and deducted, within certain limits in later years. Under pre-TRA law, §404(a)(3) also provided that, where the contribution was less than the maximum amount permitted, the unused amount up to the maximum limit for that year, called a "limit carryforward," could be carried over and used in later years. The total amount of the limit carryforward that could be deducted in a later year could not exceed 25% of the aggregate compensation of the employees covered by the plan during the carryforward year.[484] Also under pre-TRA law, the term "stock bonus" or "profit sharing" trust was defined to exclude money purchase pension plans.[485]

Employer contributions to defined benefit plans are required to meet the minimum funding standards of Code §412. The deduction for contributions to defined benefit plans is limited to the greatest of:

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year;

(2) The level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current service credits of all employees under the plan (adjusted, if applicable, by a 10-year amortization of experience gains or losses) over the remaining future service of each employee; or

(3) An amount equal to the normal costs of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits plus experience gains or losses in equal annual payments over 10 years.[486]

Under the minimum funding standard, the portion of the cost of a plan that must be paid for a year depends on the nature of the cost. Each funding method allocates costs between "normal costs" which are generally required to be funded currently and "past service costs" which are spread over a period of years. The "full funding limitation" of Code §412 eliminates the requirement that additional employer contributions be made for a period during which the plan is fully funded. Employer contributions in excess of the deduction limits provided by the Code are not currently deductible but, as in the case of defined contribution plans, a deduction carryover is generally allowed.

Money purchase pension plans are treated as defined benefit plans for purposes of computing contribution limitations and carryovers. Thus, employer contributions to a money purchase plan are generally deductible to the extent required by the minimum funding standard. For money purchase plans, this is the contribution rate specified by the plan.

If an employer maintains a combination of pension plans (defined benefit or money purchase plans) and the same employee or employees participate therein for the same year, the employer's deduction for contributions for that year is generally limited to the greater of either 25% of the aggregate compensation of employees covered by the plans for the year or, the contribution necessary to meet the minimum funding requirements of the pension plan for the year.

Note that, under pre-TRA law, if the employer maintained both a defined benefit plan and a money purchase plan for the same employee for the same year, the limit did not apply because both plans were treated as pension plans.

In revising the law to eliminate the unused limit carry forward for defined contribution plans, and requiring that a combined limit be imposed when contributions are made to both defined benefit and money purchase plans for the same employee for the same year, Congress provided no justification for the elimination of the unused limit carryforward [487] and indicated that, with regard to the treatment of the combination of money purchase and defined benefit plans, it saw no reason why the combination of plans should not be subject to the same overall deduction limits as a combination of defined benefit and an annuity, profit sharing or stock bonus plan.[488]

Under pre-TRA law, there was no tax imposed on nondeductible contributions made by employers to qualified plans and SEPs.

B. Overview

The Act revised Code §404 by repealing the unused limit carryforward applicable to profit sharing and stock bonus plans and by subjecting money purchase plans, when maintained in combination with defined benefit plans of an employer and in which the same employee or employees of the employer participate, to the same overall contribution limitation rules as apply to the combination of defined benefit and defined contribution plans.

Also, the Act imposed a 10% tax on the employer making distributions to a qualified plan for contributions in excess of the deductible limits under Code §404.

[482] Code §404.
[483] Code §404(j).
[484] Code §404(a)(3).
[485] *Id.*
[486] Code §404(a)(1).

[487] *See* Senate Rep., p. 633.
[488] Senate Rep., p. 633.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The provisions apply, in general, to the employer's taxable years beginning after 1986. There is, with regard to the repeal of the unused limit carryforward, a transition rule protecting limit carryforwards that were unused before 1987.

C. *Detailed Analysis*

1. *Repeal of Limit Carry Forward*

The Act amended Code §404(a)(3)(A) concerning the limits on deductible contributions to stock bonus and profit sharing trusts by eliminating the rules permitting the carryforward of amounts by which the contribution for a particular year were less than the maximum amount permitted for that year. Thus, if an employer's contribution for a particular year is less than the maximum amount for which a deduction may be allowed, the unused limit may no longer be carried forward to subsequent years.[489]

The revised rules do not affect pre-TRA law concerning deduction carryforwards. Therefore, amounts paid to a profit sharing or stock bonus trust in excess of the 15% deduction limit for a particular pre-TRA year, may be deductible in the succeeding years in order of time, provided the deduction in any of the succeeding years does not exceed the 15% deduction limit for that year.[490]

2. *Deduction Limits Applicable to Combination Defined Benefit and Money Purchase Plans*

Under pre-TRA law, the combined limit for contributions to pension plans and stock bonus or profit sharing plans treated money purchase plans as pension plans and, therefore, no combined limit was applied where an employer maintained both a defined benefit and a money purchase plan. The Act amended Code §404(a)(7) to provide that the combined limit applies even where one of the plans is a money purchase pension plan: specifically, if an employer (1) maintains one or more defined contribution plans; (2) has one or more defined benefit plans and has one or more employees participating in more than one such plan; and (3) contributes to one or more qualified defined contribution plans (which includes money purchase plans), and one or more qualified defined benefit pension plans for a taxable year, then, the amount deductible in that taxable year must satisfy the overall deduction limits set forth in Code §404(a)(7). This overall deduction limit is the greater of 25% of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plans or the amount of contributions made to or under the defined benefit plans to the extent necessary to satisfy the minimum funding standards of §412.[491]

Note: As under pre-TRA law, the combined limits do not apply where an employer does not have an employee that participates in both a defined benefit and a defined contribution plan of the employer.[492]

Note: The Act also provides that any plan described in Code §412(i), that is, fully insured plans, will be treated as defined benefit plans for these purposes.[493] In such cases, the annual premium is deemed to be the amount required to meet the minimum funding requirement.[494]

3. *Nondeductible Contributions Subject to 10% Excise Tax*

The Act subjects employers making nondeductible contributions to a qualified plan to a 10% excise tax.[495] The amount of the nondeductible contributions is determined as of the close of the employer's taxable year.[496]

Nondeductible contributions are defined as the sum of the amounts contributed to qualified employer plans that exceed the deduction limits in Code §404 and the amount of the prior year's contributions in excess of the deduction limits, reduced by amounts returned to the employer during the year, if any, and the portion of the prior year's nondeductible contributions that is deductible in the current year.[497]

A qualified employer plan is defined as: (1) any plan that satisfies the requirements of Code §401(a) that includes a trust exempt under §501(a); (2) an annuity plan described in Code §403(a); and (3) any simplified employee pension plan within the meaning of Code §408(k).[498] In the case of a plan that provides contributions or benefits for employees who are self-employed individuals (as defined in Code §401(c)(1)), the "employer" is the person treated as the employer in Code §401(c)(4).[499] Thus, for example, a partnership will be treated as the employer of each partner and an individual who owns the entire interest in an unincorporated trade or business will be treated as the employer.

Note: The excise tax applies to tax-exempt employers.[500] The tax applies to contributions that would, if the employer were not exempt, be nondeductible.[501]

Note: The Conference Report also imposes a limit of $200,000 on the amount of compensation that may be taken into account in computing deductions for plan contributions. This limit is to be adjusted for cost-of-living increases at the time and in the same manner that the overall limits on annual benefits under Code §415(d) are adjusted.[502]

The excise tax has a broad sweep because it contains no exceptions for nondeductible contributions such as those pre-1987 contributions in excess of the applicable deduction limits; amounts that provide benefits in excess of the currently applicable Code §415 limits pursuant to Code §404(j); amounts that are nondeductible because of unreasonable actuarial assumptions and those contributions required to satisfy ERISA minimum funding requirements or plan provisions. For these reasons, it is particularly important to amend, as quickly as possible, plans that permit contributions in excess of the revised minimum funding

[489] Act §1231(a). Code §404(a)(3)(A)(ii).
[490] *Id.*
[491] Act §1231(b). Code §404(a)(7)(A).
[492] Act §1231(b). Code §404(a)(7)(C).
[493] Act §1231(b). Code §404(a)(7)(D).
[494] Conf. Rep., p. II-481.
[495] Act §1131(c). Code §4972(a).
[496] *Id.*
[497] Act §1131(c). Code §4972(c).
[498] Act §1131(c). Code §4972(d)(1).
[499] Act §1131(c). Code §4972(d)(2).
[500] Conf. Rep., p. II-481.
[501] *Id.*
[502] *Id.*

requirement even though, in general, such amendments are not necessarily required to be made until January, 1989.[503]

4. Effective Dates

The 1986 TRA rules concerning the repeal of the unused limit carryforward and the rule imposing the combined plan deduction limitation on money purchase and defined benefit plan combinations are effective for taxable years beginning after 1986.

Note: The Conference Report, at p. II-481, indicates that the rules relating to deduction limits apply to the *employer's* taxable years beginning after 1986.

The Act contains a special grandfather rule effectively protecting limitation carryforwards accumulated in past years.[504] The Act provides that the deduction limit for any taxable year beginning after December 31, 1986, may be increased by the unused pre-1987 limitation carryforwards, provided the increased amount does not exceed 25% of compensation otherwise paid or accrued in the carryforward year to employees who benefit under the plan.[505]

The Act defines the unused pre-1987 limitation carryforward as the amount by which the 15% limit applicable to a profit sharing or stock bonus plan (as in effect on the day before the date of enactment of the Act) for any taxable year beginning before January 1, 1987, exceeded the amount paid to the trust for that taxable year (to the extent the excess was not taken into account in any taxable year before the year for which the limit is being calculated).[506]

The tax on nondeductible contributions applies to taxable years beginning after 1986.

[503] Act §1140.
[504] Act §1231(a). Code §404(a)(3)(A)(v).
[505] Act §1231(a). Code §404(a)(3)(A)(v)(I).
[506] Act §1131(a). Code §404(a)(3)(A)(v)(II).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 55

INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAs) AND SIMPLIFIED EMPLOYEE PLANS (SEPs)

Marilyn E. Nelson, Esq.
Stuart M. Lewis, Esq.
Silverstein and Mullens
Washington, D.C.

I. New Provisions Affecting IRAs

A. Introduction

1. Pre-1986 TRA

Under pre-1986 TRA law, Code §219(a) and (b) permit an individual under age 70½ to deduct an annual contribution to an individual retirement arrangement (IRA) equal to the lesser of $2,000 or 100% of compensation (earned income, in the case of income from self-employment). The deduction is allowed without regard to whether the individual is covered under an employer's retirement plan. As an alternative to making deductible contributions to an IRA, a participant in an employer-sponsored retirement plan may make deductible voluntary contributions to a qualified plan, generally limited to the lesser of $2,000 or 100% of compensation for the year (or $2,250 if a spousal IRA is added).[1]

A married individual is allowed an additional deduction up to $250 (for a total of $2,250) for contributions to an IRA for the benefit of the spouse if the couple files a joint income tax return for the applicable year, the spouse has not attained age 70½, and the spouse has no compensation for the year.[2] The spouses may divide the contribution between them as they choose, so long as neither contribution exceeds $2,000. Since alimony received by a divorced spouse is treated as compensation for purposes of the IRA deduction limit,[3] a divorced spouse may contribute up to $2,000 of alimony and deduct the amount of the contribution from gross income.

An individual may contribute to an IRA for a taxable year up to the time for filing the return for that taxable year, not including extensions.[4] If the individual borrows the amount to be contributed to the IRA, the interest on the obligation is allowed as a deduction, unlike the provision of Code §265(2), which disallows deductions for indebtedness incurred to make tax-exempt investments. This disparity of treatment results because the income from an IRA is not wholly exempt, but only deferred until the principal and income from the IRA are withdrawn.

Under pre-1986 TRA law, premature withdrawals from an IRA (prior to age 59½) are includible for tax purposes in the owner's gross income and are also subject to an additional tax of 10%.[5] Investing IRA funds in any collectible, which includes stamps or coins, is deemed a distribution under Code §408(m), includible in the income of the owner of the IRA. The owner may withdraw funds from an IRA without penalty after age 59½; distributions must commence at the latest as of April 1 of the calendar year following the year in which the owner attains age 70½ or retires, whichever is later.[6] The surviving spouse may roll over distributions received after an employee's death into any type of qualified plan or IRA.[7]

2. Reasons for Change

When the IRA provisions of the Code were originally enacted in 1974 (in the Employee Retirement Income Security Act), they were not available to individuals who were active participants in employer-provided plans.[8] Congress eliminated the "active participant" restriction in 1981 in the Economic Recovery Tax Act (ERTA) and extended IRA provisions to all individual taxpayers, with the expressed purpose of raising the level of personal savings plans and making available uniform discretionary retirement savings arrangements.[9]

The Senate Finance Committee ("the Committee") found, however, that the expanded IRA provisions have not met their intended purposes.[10] The Senate Report cites data showing that, first, the level of aggregate personal savings has not increased discernibly since 1981, and secondly, that IRA utilization is lowest among taxpayers with adjusted gross income (AGI) under $30,000, a group that represents 76% of all taxpayers. The rate of investment in IRAs is highest among those with AGI in excess of $50,000.[11] The Committee was persuaded that the taxpayers in the higher income group would have made independent retirement savings without regard to the tax incentives and that the lower tax rates of the bill would themselves stimulate

[1] Pre-1986 TRA Code §219(b)(3).
[2] Pre-1986 TRA Code §219(c).
[3] Code §219(f)(1), as amended by the Tax Reform Act of 1984.
[4] Code §219(f)(3)(A), as amended by the TRA of 1984.
[5] Pre-1986 TRA Code §72(o).
[6] Pre-1986 TRA Code §§408(b)(3), 408(a)(6).
[7] Pre-1986 TRA Code §402(a)(7).
[8] *Report of the Senate Finance Committee, to Accompany H.R. 3838, Tax Reform Act of 1986*, S. Rep. No. 313, 99th Congress, 2d Sess. (hereinafter "Senate Report") (May 29, 1986) at 542.
[9] *Id.*
[10] *Id.*
[11] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

additional saving, thereby eliminating the need for deductible IRAs for those who participate in employer-provided retirement plans.[12]

Therefore, the Committee recommended reinstating the pre-ERTA rules limiting IRA deductions to taxpayers not covered by employer-provided retirement plans. At the same time, the Committee's desire to continue a tax incentive for discretionary retirement savings provided the stimulus for the nondeductible IRA contributions element of the new bill.[13] In addition, the Committee acknowledged the anomaly of the current law's spousal deduction limit, in the case of a spouse whose annual earnings total less than $250, and the Committee's bill reflects a change in the spousal IRA rules.[14]

B. Overview

1. Provisions

Post-1986 TRA law makes sweeping revisions to the rules for deductibility of IRA contributions, making saving for retirement more complicated and contributing to an IRA less attractive for many taxpayers. Wage earners who are not "active participants" in an employer-maintained retirement plan will still be able to make deductible IRA contributions as under present law, to a limit of the lesser of $2,000 or 100% of gross income. For such wage earners the additional $250 contribution for the benefit of the noncompensated spouse is also available, with a change that allows a spouse to elect to be treated as having no compensation. However, present-law IRA provisions for taxpayers who are active participants in an employer-sponsored pension or profit-sharing plan are greatly restricted. Individuals with AGI over $35,000 and couples filing jointly with AGI over $50,000 (figured before any IRA deductions) will no longer be allowed any IRA deductions if they have such other retirement plans. Deductions for single individuals with AGI between $25,000 and $35,000 and couples with AGI between $40,000 and $50,000 will be phased out ratably as income rises above the lower limits, and voluntary employee contributions to a qualified plan will no longer be allowed.

The revisions permit individuals to make nondeductible IRA contributions to the extent that deductible contributions are not allowed, to the limit of the lesser of $2,000 ($2,250 if a spousal IRA is added) or 100% of compensation. Income from nondeductible contributions is not taxable until distributed to the owner. Uniform distribution rules and uniform basis recovery rules are extended to IRAs.

2. Effective Dates

Section 1103 of the Act makes the new provisions for the spousal IRA election effective beginning with the 1985 taxable year. Other provisions for eligibility, contributions, and basis recovery rules applied to distributions are effective for taxable years beginning after December 31, 1986. Uniform distribution rules are generally effective for years beginning after December 31, 1988.

[12] *Id.*
[13] *Id.* at 543.
[14] Senate Report.

C. Detailed Analysis

1. Eligibility

a. Active Participant Status

Section 1101 of the Act amends Code §219 to limit the deduction for contributions to an IRA available to "active participants" in an employer-maintained retirement plan. Specifically, the restriction applies to participants in (i) a qualified pension, profit-sharing, or stock bonus plan described in §401(a), (ii) a qualified annuity plan described in §403(a), (iii) an annuity contract under §403(b), (iv) a simplified employee pension plan under §408(k), (v) a federal or state government employee retirement plan, and (vi) a trust under §501(c)(18).[15]

Note: Specifically excepted from active participant status are (i) participants in a §457(b) eligible deferred compensation plan, (ii) members of Armed Forces Reserve components (unless an individual has qualified for "active duty" status by serving in that capacity in excess of 90 days during the year), and (iii) volunteer firefighters with accrued benefits no greater than $1,800 as of the beginning of the taxable year.[16]

The determination of "active participant" status is made without regard to whether an individual's rights under the employer-sponsored plan are nonforfeitable (*i.e.*, vested).[17] Moreover, active participant status depends upon the type of plan in which the individual is eligible to participate. In the case of a defined benefit pension plan, an individual is treated as an active participant if the individual satisfies the conditions for eligibility for any part of the plan year within the individual's taxable year, even if the individual elects not to participate.[18] However, the eligible employee under a defined contributions plan is not treated as an active participant unless the employer makes a contribution to the employee's account. Under a money purchase pension plan, an individual is an active participant if an employer contribution is required to be allocated to the individual's account with respect to the plan year ending with or within the individual's taxable year, even if the individual is not employed at any time during the plan year.[19] Any employer contribution added or any forfeiture allocated to the individual's account in a profit-sharing or stock bonus plan during the individual's taxable year causes the individual to be an active participant.[20] The conference agreement clarifies that elective contributions (*e.g.*, elective deferrals under a qualified cash or deferred arrangement) are treated as employer contributions.[21] And finally, an employee who makes a voluntary or mandatory contribution in the employee's taxable year is treated as an active participant.[22]

Active participants with adjusted gross income (AGI) in excess of a fixed amount may not make deductible

[15] Act §1101(a), adding new Code §219(g)(5).
[16] Act §1101, adding new Code §§219(5) and (6).
[17] *Id.*
[18] Senate Report at 543-44.
[19] Senate Report at 544.
[20] *Id.*
[21] *Conference Report on H.R. 3838*, H.R. Rep. No. 841, 99th Cong., 2d Sess. (hereinafter "Conference Report")(Sept. 18, 1986) at II-378.
[22] Senate Report at 544.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

contributions to IRAs. Furthermore, as income of active participants rises above an "applicable dollar amount," the deductible amount of the IRA contribution is reduced ratably, and it is phased out completely when AGI reaches $10,000 above those limits. In the case of an individual, the applicable dollar amount of AGI is $25,000; $40,000 in the case of a married couple filing jointly; and $0, in the case of a married couple filing separately. Thus, to those limits, active participants may make the maximum amount of deductible contributions to an IRA ($2,000 for an individual and $2,250 with the spousal IRA added). Individuals with AGI in excess of $35,000, couples filing jointly with AGI over $50,000, and couples filing separately with AGI over $10,000 are ineligible to make any deductible contributions to an IRA. In the case of a married individual filing a joint return, the limitation applies if either the individual or the individual's spouse is an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the individual's taxable year.[23]

Note: The ending of the plan year has special significance for active participants who change jobs and move to one without an employer-maintained retirement plan. Any overlap of the plan year with the individual's taxable year may make such an individual ineligible for a deductible IRA.

b. Nonparticipant Status

If neither the individual nor the individual's spouse is an active participant in an employer-maintained retirement plan, the individual is eligible to make deductible contributions to an IRA as under present law. In the case of a two-worker married couple when one spouse is an active participant and the other is not, filing separately will give the nonparticipant spouse the privilege of making the maximum contribution permitted to a deductible IRA.[24]

Comment: A beneficiary of a retirement plan who is also a wage earner and not an active participant in an employer-maintained plan would be eligible, under the new rules, to make deductible IRA contributions.

2. Amount of Contribution

a. Nonparticipants

For those who are not active participants in an employer-maintained retirement plan, limits on deductible contributions are the same as under present law. The amount of the contribution is the lesser of 100% of compensation (or earned income, in the case of a self-employed individual) or $2,000, with no applicable dollar amounts placed on AGI.[25] The spousal IRA addition, as under present law, is $250. If the spouse earns a small amount of income, §1103 of the Act permits the spouse to elect to be treated as having no compensation for the year.[26] In the case of a two-earner married couple neither of whom is an active participant in a retirement plan, the maximum deductible amount is $2,000 for each. Nonparticipants may elect to have their deductible contributions treated as nondeductible.[27]

b. Active Participants

Active participants with AGI below the applicable dollar amount may may maximum deductible IRA contributions of $2,000. In the case of AGI over the applicable dollar amount, the deductible contribution is reduced by an amount that bears the same ratio to the applicable dollar limit as the taxpayer's AGI in excess of the applicable dollar amount bears to $10,000.[28] For example, in the case of a single individual who is an active participant with AGI of $30,000, the deductible amount of the IRA contribution would be $1,000 ($5,000 AGI in excess of $25,000 = 50% of $10,000; $2,000 reduced by 50% = $1,000). The IRA deduction limit is $0 for married couples filing separately if a spouse has AGI above $10,000. In the case of a married couple filing jointly with AGI of $49,000, the deductible amount would be reduced by 90%, or $1,800, thus allowing a deductible contribution of $200. Until the AGI reaches the phaseout amount, there is a floor of $200 on deductible contributions.[29] In addition, any deductible amount is rounded to the next lowest multiple of $10.[30]

Note: For purposes of applying the dollar limitations, AGI is calculated without regard to deductible IRA contributions, but with regard to taxable Social Security benefits and passive loss limitations.[31]

To the extent that they may not make deductible contributions, individuals may make nondeductible IRA contributions. Thus, an individual who is limited to making a deductible contribution of $500 may make a maximum nondeductible contribution of $1500 ($1750 in the case of a spousal IRA). Individuals with income greater than the phaseout amount may make the maximum nondeductible contribution of $2,000.[32] Moreover, §1102 of the Act permits a taxpayer to elect to treat any deductible contribution allowed as a nondeductible contribution.[33]

Nondeductible contributions may be placed in separate accounts or in the same account with deductible contributions. For the individual taxpayer's recordkeeping convenience, separate accounts may be advisable. However, because of the aggregation rules (*see* 3, a *infra*), it is not necessary to segregate the two types of contributions.

A taxpayer who makes a nondeductible contribution to an IRA must designate it on the tax return for the taxable year as a contribution for which a deduction is not allowable under Code §219.[34] The taxpayer may make such designated nondeductible contributions up to the due date of the tax return for the taxable year and may change the designation from deductible to nondeductible or vice versa in an amended return for the taxable year.[35]

[23] Act §1101(a), adding §219(g)(1) to the Code.
[24] Act §1101(a), adding subsection (4) to Code §219(g).
[25] Conference Report at II-377.
[26] Act §1103, amending Code §219(c)(1)(B).
[27] Act §1102(a), adding redesignated Code §408(o)(2)(B)(ii).
[28] Act §1101(a), amending Code §219(g)(2) and (3).
[29] Act §1101, amending Code §219(g)(2)(B).
[30] New Code §219(g)(2)(C).
[31] Act §1101, amending Code §219(g)(3).
[32] Act §1102, amending Code §408(o)(2).
[33] New Code §408(o)(2)(B)(ii).
[34] Act §1102(a), amending Code §408(o)(2)(C).
[35] Conference Report at II-378.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Caveat: §1102 of the Act adds a penalty of $100 for overstatement of the amount of the designated nondeductible contributions made for any taxable year.[36]

3. Distributions

a. General

The Act extends the uniform basis recovery rules to IRAs. Moreover, IRA distributions generally are subject to the amended uniform distribution rules. Distributions must satisfy the requirements of Code §401(a)(9).[37] Taxation of earnings on nondeductible contributions will be deferred until distributions begin; the contribution made with after-tax dollars will not be taxable, but the distributions will be prorated among earnings, principal, and deductible contributions.[38] Under special rules applicable to IRAs under Code §72, all IRAs of an individual are aggregated and treated as one contract, and all distributions during a taxable year are treated as a single distribution. If a taxpayer has made both deductible and nondeductible contributions, any distribution during a taxable year will be treated as partially a return of the deductible contribution, of the nondeductible contribution, and of earnings for purposes of determining the amount includible in income for the taxable year.[39]

Example: Assume that (1) an active participant makes a $2,000 contribution for the 1987 taxable year, $1,500 of which is deductible, (2) no withdrawals are made from the IRA during the taxable year, (3) the account balance at the end of the taxable year is $2,200, and (4) no prior IRA contributions have been made. For 1988, assume that (1) the individual makes a designated nondeductible IRA contribution of $2,000 to another IRA account, (2) no withdrawals are made from the IRA during the taxable year, and (3) the aggregate account balance as of the end of the taxable year for both IRA accounts is $4,600. In this individual's 1989 taxable year, no IRA contributions are made and the individual withdraws $1,000 from the account to which a contribution was made for the 1987 tax year. At the end of the 1989 taxable year, the aggregate account balance of both IRA accounts is $4,000. The nondeductible percentage of the $1,000 withdrawn is equal to the percentage the total nondeductible contributions ($2,500) are of the total account balance at the end of the taxable year ($4,000) plus distributions during the year ($1,000). Thus, 2,500/5000, or 50% of the amount withdrawn ($500) is treated as a return of nondeductible contributions, and therefore not taxable.[40]

b. Mandatory Distributions

Distributions from an IRA must begin no later than April 1 of the calendar year following the year in which the owner reaches age 70½, regardless of whether the owner has retired.[41] An individual is subject to sanctions for failing to comply with this requirement.[42] Required distributions made from IRAs cannot be rolled over into another qualified plan in order to avoid the distribution rules of Code §401(a)(9).[43] Consistent with this requirement, rollovers of distributions received by the surviving spouse after an employee's death are restricted to IRAs, a change from present law, which permits a rollover into any type of qualified plan.[44]

c. Premature Withdrawals

An early distribution is a withdrawal by the owner prior to age 59½, except for disablement or death. As under present law, an additional tax of 10% is imposed on early distributions from IRAs.[45] IRAs are subject to most of the exemptions from that tax of the uniform distribution rules, with two exceptions.[46] Early distributions from an IRA because of early retirement or to pay medical expenses, unlike distributions made from qualified plans, are not exempt from the additional tax. However, the life annuity exemption applies to an IRA. Under this provision, a distribution prior to the owner's age 59½ is exempt from the additional tax if it is part of a series of substantially equal periodic payments for the life of the employee.[47] To be eligible, the annuity payments must begin after the employee's separation from service and be made at least annually.

4. Miscellaneous Provisions

Section 1102 of the Act retains the pre-TRA rule with respect to the time that contributions to an IRA must be made: up to the due date of the tax return for the taxable year without extensions. Permissible investments for IRAs have been expanded to include gold and silver coins issued by the United States government.[48] The deduction for interest on loans for investment in deductible IRAs is effectively denied through the general disallowance of personal interest under the Conference Agreement.[49]

D. Planning Suggestions

Since saving for retirement through IRAs becomes far more complicated under the new provisions of the Act, taxpayers who have been investing in IRAs as a supplement to employer-maintained retirement plans should begin now to consider their priorities for tax-deferred savings beginning in 1987, recognizing that only the earnings from nondeductible contributions will be deferred and that early withdrawal of nondeductible contributions will have the effect of withdrawing a prorated portion of deductible IRAs. Moreover, because of the penalty for overstatement of designated nondeductible contributions, those who wish to make such contributions should estimate their contributions conservatively if they plan to invest at the beginning of the year.

[36] Act §1102(d), adding new Code §6693(b).
[37] Act §1852(a)(1)(B), amending Code §408(b)(3). *See* Chapter 57 of this Portfolio for discussion of new basis recovery rules and the uniform distribution rules.
[38] Act § 1102(c), amending Code §408(d).
[39] *Id.*
[40] Conference Report at II-379-380.
[41] Act §1852(a)(1)(A) and (B), amending Code §§408(a)(6) and 408(b)(3).
[42] *See* Chapter 57 for discussion of requirements of uniform distribution rules.
[43] Act §1852(a)(5), amending Code §408(d)(3).
[44] Act §1852(b)(4), amending Code §402(a)(7).
[45] Act §1123, amending Code §72(t); Conference Report at II-455.
[46] *See* Chapter 57, *infra*.
[47] Act §1123, amending Code §72(t)(2)(A)(iv); Conference Report at II-456.
[48] Act §1144, amending Code §408(m) by adding subparagraph (3).
[49] Conference Report at II-154; Act §511.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

A taxpayer's earnings on nondeductible IRAs will require a much longer investment period to neutralize the early withdrawal tax (the "break-even" point) than would the same investment in a deductible IRA.[50] As a result, other types of investments with tax-deferred earnings may seem more attractive.

II. Simplified Employee Pension Plans

A. Introduction

Simplified employee pension plans (SEPs) are employer-established plans that are funded through individual retirement accounts but qualify for greater contributions than IRAs. If the requirements of §408(k) are satisfied, the annual deduction limit is roughly comparable to that for qualified defined contribution plans; *i.e.,* 15% of (i) the compensation from the employer that is includible in the employee's gross income or (ii) the employer contribution to the SEP that is includible in the employee's gross income, up to $30,000 per year.[51] In order to qualify, the SEP must meet specified requirements, including nondiscrimination and participation requirements. Under the pre-1986 TRA participation requirement, a contribution must be made under the SEP for each employee who has attained age 25 and has performed service during at least three of the immediately preceding five calendar years.[52]

B. Overview

The principal change made to the SEP rules by the Act was the addition of elective salary deferral provisions patterned after those available under §401(k) plans. Under these provisions, participants in qualifying SEPs will be able to elect to have salary reduction contributions made to the SEPs and will benefit from a tax deferral comparable to that available under §401(k) plans. Special requirements were added for SEPs that permit such salary deferral elections.

Several other changes were also made to the SEP provisions. One changes the nature of the income tax treatment of SEPs so that, for tax purposes, SEPs are treated like qualified plans rather than like IRAs. Thus, for example, a deduction is allowed for the employer contribution and an exclusion from income (like a salary reduction contribution in a §401(k) plan) is provided to the participant instead of requiring the participant to include the contribution in income and take a corresponding deduction on his or her individual tax return. In addition, the participation and integration requirements for SEPs were modified to make these rules more compatible with the rules for qualified plans.

C. Detailed Analysis

1. Salary Reduction Arrangements

The Act adds new Code §408(k)(6), permitting employees to make salary reduction contributions.[53] Under §408(k)(6), if certain requirements are satisfied, a participating employee may elect to have the employer make salary reduction payments to the SEP on his or her behalf as an "elective employer contribution."

In order to make this election available, four principal requirements must be satisfied by the SEP. First, the salary reduction election must be made or be in effect with respect to not less than 50% of the employees of the employer.[54] Second, the "deferral percentage" for each year for each highly-compensated [55] employee eligible to participate must not be more than the product derived by multiplying the average "deferral percentage" for all nonhighly-compensated employees by 1.25%.[56] Third, the salary reduction election may not be available in a year if the employer has more than 25 employees at any time during the preceding year.[57] Fourth, this election is not available to SEPs maintained by state and local governments, or political subdivisions thereof, or any agency or instrumentality thereof or any organization exempt from tax under the Internal Revenue Code.[58]

The SEP deferral percentage for an employee for a year is the ratio of the amount of elective employer contributions actually paid over to the SEP on behalf of the employee for the year to the employee's compensation for the year.[59] In calculating deferral percentages, matching and nonelective contributions apparently may not be taken into account in determining the deferral percentage.[60]

Three important distinctions exist between the limits calculated under §408(k)(6) and those calculated under §401(k). First, in §401(k)(3) the limits imposed on highly-compensated employees are imposed on the average deferral for the highly-compensated group whereas in §408(k)(6) the limits are imposed on each highly-compensated employee. Thus, in a SEP none of the highly-compensated employees can rise above the limits. Second, the limits may be lower in many cases in a SEP.[61] Third, matching and employer contributions that comply with the §401(k)(2) requirements may be counted to comply with the applicable ratio tests under §401(k) whereas they apparently are not counted, as noted above, for purposes of §408(k).[62]

Note: The effect of these disparities is that in many cases a small employer may still find a §401(k) plan more advantageous than a SEP. The employer would have to balance, however, the superior tax benefits of the §401(k) plan against the generally higher administrative costs associated with it.

[50] *See, e.g.*, "IRAs Are Not Just For Retirement," 2 T.M. Financial Planning J. 190 (April 8, 1986).
[51] *See* Code §219(b)(2).
[52] Pre-1986 TRA Code §408(k)(2).
[53] Act §1108(a).
[54] Code §408(k)(6)(A)(ii).
[55] "Highly-compensated employee" has the same meaning as is used under the Act for qualified plans. *See* Code §414(q), added by Act §1114(a).
[56] Code §408(k)(6)(A)(iii).
[57] Code §408(k)(6)(B).
[58] Code §408(k)(6)(E).
[59] Code §408(k)(6)(D). For this purpose, "compensation" is defined in Code §414(s), added by Act §1115(a).
[60] The statutory provisions of §1208 of H.R. 3838 as passed by the Senate were similar in this regard to the final provisions and the Senate directed that employer and matching contributions were not to be taken into account. Conference Report at II-406.
[61] Compare Code §401(k)(3)(A)(ii) with §408(k)(6)(A)(iii).
[62] *See* Code §401(k)(3)(C).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

If a highly-compensated employee contributes more than is allowable under the 1.25 rule of §408(k)(6)(A)(iii), the excess elective employer contribution is treated as an "excess contribution." [63] Excess contributions are to be treated under rules similar to those applicable to §401(k) plans under §401(k)(8). Thus, excess contributions must be withdrawn in the first 2½ months of the following plan year to avoid a 10% excise tax under §4979.[64]

Note: The effect of these new rules is to increase the usefulness of SEPs for many small employers. Previously, a small employer that wished to use a §401(k) plan was required to actually adopt a §401(k) plan in order to achieve the salary reduction benefits. The Act, however, expands the availability of salary reduction arrangements to SEPs, thereby giving small employers an additional option. However, the rules applicable to a §408(k)(6) salary reduction arrangement are not identical to those available under §401(k) and may, in some situations, not be as advantageous. As a consequence, careful consideration should be exercised by small employers in determining whether to use a §401(k) plan or a §408(k)(6) SEP.

2. Taxation of SEPs

Post-1986 TRA Code §402(h)[65] prevents an employee from having constructive receipt by reason of salary reduction contributions made to a SEP that qualifies under §408(k)(6). In addition, §402(g)(1)[66] imposes a $7,000 limit on the amount of exclusion available for the taxable year of any individual. This $7,000 limit applies to both §401(k) plans and §408(k) plans.[67]

Note: The $7,000 limit is not a SEP limitation but a limitation on the income tax exclusion for the employee. Salary reduction contributions in excess of $7,000 will still be taxed to the employee currently.

Further, the taxation procedure for SEP contributions is changed by the Act. Instead of providing individual SEP participants with income and a corresponding deduction, the rules are made compatible with those for qualified plans. Thus, the employer contribution will be deductible to the employer [68] with an exclusion provided to the employee until such time as the employee becomes taxable on the SEP distributions.[69] The general deduction limitations, however, continue to be 15% of compensation up to $30,000, including any salary reduction contributions made under §408(k)(6).[70]

3. Participation Requirements

Post-1986 TRA participation requirements are also added for SEPs. As modified, the participation requirements of §408(k)(2) provide that the employer must make employer contribution to the SEP for each employee who has attained age 21,[71] has performed service for the employer during at least three of the immediately preceding five years and has received at least $300 in compensation from the employer for the year.[72]

For purposes of this calculation, employees who can be excluded from the participation requirements for qualified plans under Code §410(b)(3)(A) and (C) are also excluded in determining whether the SEP participation requirements are satisfied.[73] Thus, certain union employees and nonresident aliens may be excluded from the SEP.

The participation requirement is applied separately to elective arrangements.[74] Employees who are eligible to have employer contributions made on their behalf under §408(k)(6) are, however, treated as if the contribution was made.[75] The year that is used for purposes of SEPs is the calendar year except to the extent that the employer elects, pursuant to regulations, to utilize its taxable year.[76] Thus, in most cases SEPs will probably use the calendar year.

4. Integration

The Act also changes the applicable social security integration rules for SEPs. It deletes the pre-1986 TRA provisions of §408(k)(3)(D) and inserts in lieu thereof a provision requiring the SEP to comply with the integration rules of Code §401(l)(2). These are the same integration rules applicable to defined contribution qualified plans. The integration rules of §401(l)(2) do not, however, apply to salary reduction contributions under §408(k)(6).

Note: Although the SEP integration rules are effective for 1987, they are adopted by means of a reference to the integration rules in §401(l)(2), which are not effective until 1989. This discrepancy will presumably be resolved either by regulations or technical corrections legislation.

5. Effective Date

Except as otherwise noted, the new rules apply to years beginning after December 31, 1986.

III. Section 501(c)(18) Plans

A. Introduction

Trusts created before June 25, 1959, forming part of a pension plan funded solely by contributions of employees are entitled to tax exemption under Code §501(c)(18). Previously, the Internal Revenue Service concluded that

[63] Code §408(k)(6)(C)(ii).
[64] Code §4979 was added by Act §1117(b)(i).
[65] Code §402(h) is apparently mislettered and probably will eventually be relettered as §402(j). Added by Act §1108(b).
[66] Code §402(g) should be §402(i).
[67] This limit is adjusted for cost-of-living increases pursuant to Code §415(d). Code §402(g)(5).
[68] Act §1108(c), amending Code §404(h)(1).
[69] Act §1108(b), amending Code §402(h)(1). The provisions in §219(b)(2) of the Code that currently provide the limitations for SEP contributions are modified so that the limitations are now imposed under §402(h)(2) of the Code.
[70] Act §1108(b), amending Code §402(h)(2).
[71] Act §1898(a)(5) amends §§102 and 202 of the Retirement Equity Act of 1984 (REA) and §408(k)(2)(A) of the Internal Revenue Code of 1954 to reduce, from 25 to 21, the maximum age requirement that a SEP may impose for plan participation. Under REA, a pension plan could restrict participation to employees who had attained age 21 and completed one year of service, while the age restriction for employees participating in a SEP remained age 25. As a result of this amendment, which is effective for plan years beginning after the date of enactment, the maximum age that a SEP may require as a condition of participation will be 21 rather than 25.
[72] This amount (as well as the $200,000 limit under Code §408(k)(3)) are adjusted for cost-of-living increases in accordance with Code §415(d). Act §1108(d), adding subsection (8) to Code §408(k).
[73] Act §1108(d), adding Code §408(k)(2).
[74] Conference Report at II-407.
[75] Code §408(k)(2).
[76] Code §408(k)(7)(C).

contributions to pension plans exempt under §501(c)(18) were deductible as union dues by employees making those contributions.[77]

B. Overview

The Act permits salary reduction contributions to be made to an exempt §501(c)(18) trust under rules similar to those applicable under §401(k) of the Code. This change will, however, be of interest only to existing §501(c)(18) trusts since no new trusts can be established under that provision.

C. Detailed Analysis

The Act adds new §501(c)(18)(D), which permits an employee to designate certain contributions as deductible.[78] The contribution would be limited to the lesser of $7,000 or 25% of the employee's compensation includable in income for the year.[79] Further, the plan must satisfy the special nondiscrimination tests under §401(k)(3)(A)(ii).[80] Failure to satisfy that test will cause the amount to be treated as an excess contribution under a §401(k) plan.[81] Finally, the contributions must be treated as elective contributions under §402(g).[82]

These provisions are effective for taxable years beginning after December 31, 1986.

[77] *See* Rev. Rul. 54-190, 1954-1 C.B. 46, declared obsolete by Rev. Rul. 82-127, 1982-1 C.B. 215.
[78] Act §1109(a).
[79] Code §§501(c)(18)(D)(i) and 219(b)(3).
[80] Code §501(c)(18)(D)(ii).
[81] Code §501(c)(18)(D).
[82] Code §501(c)(18)(D)(iii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 56

ELECTIVE DEFERRAL LIMITATIONS AND NONDISCRIMINATION RULES FOR TAX-SHELTERED ANNUITIES

Diane J. Fuchs, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

Tax-sheltered annuity programs are retirement programs established under Code §403(b) by public schools, state and local governments and agencies thereof and certain tax-exempt organizations (including churches and certain organizations associated with churches). The amount contributed to the plan, if the plan conforms to the requirements of Code §403(b), is excluded from the employee's income for the taxable year to the extent that the payment does not exceed the employee's exclusion allowance for that year. [1] In general, the exclusion allowance is equal to 20% of the employee's includable compensation from the employer multiplied by the number of the employee's years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity. [2] Employer payments to purchase a tax-sheltered annuity contract for an employee are subject to the overall limitations on contributions and benefits applicable to qualified plans. This limit on annual additions generally is the lesser of 25% of compensation, or $30,000 (the defined contribution plan §415 limits). Certain catch-up elections allow an employer to contribute in excess of the usual percentage limits in certain years.

Under pre-1986 TRA law, there were no coverage or nondiscrimination rules that prohibited an employer's tax-sheltered annuity program from favoring highly compensated employees.

Also, under pre-TRA law, benefits under a tax-sheltered annuity program were includable in income when paid or made available.

In changing the Code §403(b) rules with regard to the maximum permitted amount of elective deferrals, Congress desired to address the disparity between those individuals who participate in plans that permit elective deferrals and those who participate in plans that do not. Under pre-TRA law, where a salary reduction arrangement was in effect, an employee could elect to exclude from income up to $30,000 a year, while those individuals whose employers did not provide salary reduction arrangements could not do so. [3] Congress dealt with this inequity by reducing the limits on contributions to a tax-sheltered annuity made pursuant to salary reduction agreements.

Congress was also concerned that there were no coverage or nondiscrimination rules under pre-1986 TRA law. Thus, employers could establish such plans for the exclusive benefit of their highly paid employees or officers. Congress determined that tax-sheltered annuity arrangements should not be permitted to cover relatively small numbers of employees and provide disproportionately large benefits to highly compensated individuals only. Rather, it determined that the opportunity to make elective deferrals should be available to all employees. [4]

Under pre-TRA law, benefits under tax-sheltered annuity programs, unlike other qualified plans, were subject to the constructive receipt rules and were subject to tax when amounts under the annuities became available. This rule was repealed because Congress saw no reason to maintain a disparity in the tax treatment of individuals covered by different types of tax-favored retirement arrangements. [5]

II. Overview

A. Contribution Limitations

In general, effective for taxable years beginning after 1986, salary reduction contributions to a tax-sheltered annuity are limited to $9,500 per year. [6] This amount is to be indexed to cost-of-living increases. [7] Special "catch-up" contributions of up to $3,000 per year (up to a maximum of $15,000) are permitted in addition to the $9,500, for employees of certain qualified organizations such as educational organizations, hospitals, home health service organizations, health and welfare service agencies, and church organizations. [8]

The annual limit on the amount of the salary reduction contribution is reduced below the $9,500 limit, dollar for dollar, by the amount excluded from an employee's income on account of the employee's elective deferrals under qualified cash or deferred arrangements pursuant to Code

[1] Employer contributions to a tax-sheltered annuity include contributions made by reason of a salary reduction agreement, whether or not evidenced by a written agreement.
[2] Code §403(b)(2).
[3] H.R. Rep. 426, 99th Cong., 1st Sess. 706 (1985) ("House Report").
[4] House Report, pp. 706 and 712.
[5] House Report, p. 732.
[6] 1986 TRA, P.L. 99-514, §1105(a)(4) (hereinafter "Act"). Code §402(g)(4).
[7] Act §1105(a). Code §402(g)(5).
[8] Act §1105(a). Code §402(g)(8).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

§401(k) or simplified employee pensions (SEPs)(under §408). [9]

Note: The 1986 TRA does not permit tax-exempt organizations to establish new cash or deferred arrangements under §401(k), but does grandfather plans that were adopted before July 2, 1986. [10]

Elective deferrals under tax-sheltered annuity programs are taken into consideration for purposes of reducing the amounts that may be contributed to a nonqualified deferred compensation plan of the employer which satisfies the requirements of Code §457 [11] and to Code §401(k) cash or deferred arrangements. [12] Further, effective for taxable years beginning after 1986, participation in a tax-sheltered annuity plan may disqualify an individual from receiving a deduction for contributions to an IRA. [13] For years beginning after 1986, for purposes of the limits imposed on contributions to defined contribution plans, contributions not excluded from an employee's income will be taken into account in the calculation of the limit on annual additions under Code §415(c).[14]

B. Coverage and Nondiscrimination Rules

In general, effective for years commencing after 1988, if an employer permits any employee to make salary reduction contributions to a tax-sheltered annuity, the employer must permit all employees to do so. [15] The following employees, however, may be prevented from making salary reduction contributions to a tax-sheltered annuity: (1) employees who participate in an eligible deferred compensation plan of the employer under Code §457; (2) employees who participate in a qualified cash or deferred (§401(k)) plan of the employer; (3) nonresident aliens; and (4) students who normally work less than 20 hours per week. [16] An employer may require a minimum contribution to a salary reduction agreement of no more than $200. [17]

Also for taxable years commencing after 1988, contributions to tax-sheltered annuity plans that are not made pursuant to a salary reduction agreement will be subject to the post-1986 TRA nondiscrimination and coverage rules generally applicable to qualified plans. [18] If a tax-sheltered annuity plan, by itself, fails to satisfy the coverage and nondiscrimination requirements of Code §§401(a)(4) and 410(b), the employer may elect to aggregate the annuity plan with its other qualified plans to demonstrate that the plan satisfies the coverage requirements. [19]

In general, church plans are not subject to the post-1986 TRA nondiscrimination and coverage requirements. [20]

III. Detailed Analysis

A. Limits on Elective Deferrals

As part of the general limit on the exclusion for elective deferrals for cash or deferred arrangements under Code §401(k), Congress added a parallel limit on contributions to tax-sheltered annuities under Code §403(b). [21] The Act set the standard limit on elective deferrals to tax-sheltered annuities at $9,500. [22] The Conference Report clarifies that the $9,500 annual limit applies until the cost of living adjustments to the annual limit on general elective deferrals under a qualified cash or deferred arrangement raises that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity also will be indexed in the same manner as the indexing of the annual limit for elective deferrals under CODAs. [23] Further, elective deferrals under tax-sheltered annuity arrangements are reduced by elective contributions to cash or deferred arrangements under Code §401(k) and SEPs.

Elective deferrals, for purposes of post-TRA Code §402(g), are defined, in pertinent part, as any employer contribution to purchase an annuity contract under §403(b) under a salary reduction agreement (within the meaning of §3121(a)(5)(D)). [24]

Note: The definition of elective deferrals to which the annual limit applies does not include a deferral where an employer allows employees a one-time election to participate in a contributory defined benefit plan with a single mandatory contribution rate or a tax-sheltered annuity program with elective deferrals. Also, if an employee is required to contribute a fixed percentage of compensation to the tax-sheltered annuity as a condition of employment, the contributions are not treated as elective deferrals. These two situations are not intented to be the only situations in which contributions are not to be treated as elective deferrals. The Conference Report indicates that the Secretary of the Treasury must issue guidance to employers on other contributions that are not to be treated as elective deferrals. [25]

Note: Because the post-1986 TRA limit applies to elective deferrals only, non-elective employer or employee contributions may be made that exceed the limit. Starting in 1989, however, the post-1986 TRA nondiscrimination and coverage rules must be satisfied. *See* discussion *infra*.

The Act provides an exception to the $9,500 annual limit in the case of employees of an educational organiza-

---

[9] Act §1105(a). Code §402(g)(3) and (4).

[10] Act §1116(f)(2)(B). In the case of a state or local government (or subdivision thereof), the grandfathering protection extends to §401(k) plans adopted before May 6, 1986.

[11] Act §1107(a). Code §457(c)(2).

[12] Act §1105(a). Code §402(g)(3).

[13] Act §1101(a). Code §219(g).

[14] Act §1106(e). Code §415(c)(2)(B). Note that Act §1106(i)(2) provides a special effective date for collective bargaining agreements. In the case of plans maintained pursuant to collective bargaining agreements ratified before March 1, 1986, the amendments made by Act §1106 to tthe §415 limits do not apply to years beginning before the earlier of: (i) the date on which the last applicable collective bargaining agreement terminates (determined without regard to any extension made after February 28, 1986), or (ii) January 1, 1989.

[15] Act §1120(b). Code §403(b)(10)(A)(ii).

[16] Act §1120(b). Code §403(b)(10)(A).

[17] Act §1120(b). Code §403(b)(10)(A)(ii).

[18] Act §1120(b). Code §403(b)(10)(A)(i). Specifically, post-TRA §403(b)(10)(A)(i) references the requirements of §401(a)(4), (5), and (26) and §410(b).

[19] H.R. Rep. 841, 99th Cong., 2d Sess., p. II-419 (1986) ("Conference Report").

[20] Act §1120(a), adding Code §403(b)(1)(D).

[21] Act §1105(a) adding Code §402(g).

[22] *Id.* Code §402(g)(4).

[23] Conf. Rep., p. II-405.

[24] Act §1105, Code §402(g)(3)(C).

[25] Conf. Rep., p. II-405.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tion, a hospital, home health service agency, health and welfare service agency, church, or convention or association of churches. Under the exception, any eligible employee who has completed 15 years of service with the employer is permitted to make an additional salary reduction contribution under the following conditions:

(1) the additional contributions can be no more than $3,000 in any one year;

(2) in the aggregate, the total amount of contributions do not exceed $15,000, reduced by tax-sheltered annuity contributions not included in gross income in any prior taxable years, and

(3) in no event may the exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit. The lifetime limit on elective deferrals for an individual, solely for purposes of this special catch-up rule, is $5,000 multiplied by the number of years of service that the individual performed with the employer. [26]

The Act amends Code §6051(a) concerning the requirement that an employee be provided with a Form 1099 concerning compensation received from the employer. It requires that a Form 1099 be provided showing the total amount of elective deferrals pursuant to the general elective deferral provisions, including deferrals with regard to tax-sheltered annuities and Code §457 plans. [27]

The limitations on elective deferrals, applicable to tax-sheltered annuities, apply to taxable years beginning after 1986. [28] There is a special rule extending the effective date for deferrals under plans maintained pursuant to collective bargaining agreements. Where a plan is maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, and the agreements were ratified before March 1, 1986, the elective deferral rules do not apply to elective deferrals for taxable years beginning before the earlier of the date on which the last of such collective bargaining agreements terminates, or January 1, 1989. [29] Although the limits do not apply to contributions made to plans maintained pursuant to collective bargaining agreements until the date described above, such contributions must be taken into account for purposes of applying the limit on elective deferrals to other plans. [30]

B. Nondiscrimination Requirements for Tax-Sheltered Annuities

Effective for years beginning after 1988, the 1986 TRA added nondiscrimination and coverage requirements applicable to tax-sheltered annuities. The Act provides that all tax-sheltered annuity plans must satisfy these rules except in the case of contracts purchased by a church. [31] For purposes of the church exclusion, a church is defined in the same way that it is defined in Code §3121(w)(3)(A). Further, the term includes any qualified church-controlled organization (as defined in §3121(w)(3)(B)). [32]

1. Elective Deferrals

If an employer permits elective deferrals, then all employees of the organization must be able to make elective deferrals. The employer, however, may impose a minimum contribution requirement but the amount may be no more than $200. [33] For purposes of elective deferrals, the Act provides that an employer may exclude any employee who participates in an eligible deferred compensation plan (within the meaning of Code §457), or a qualified cash or deferred arrangement of the organization, or another annuity contract described Code §403(b). Any nonresident alien described in Code §410(b)(3)(C) may also be excluded. Students who normally work less than 20 hours per week may be excluded (subject to the conditions applicable under Code §410(b)(4)). [34] The Conference Report, at p. II-418, notes that the 1986 TRA rules governing elective deferrals are to apply, under Treasury regulations, "with respect to the entity of the employer sponsoring the tax-sheltered annuity program."

2. Non-Elective Deferrals

a. In General

In general, non-elective or matching contributions must meet all of the post-1986 TRA coverage and nondiscrimination rules applicable to qualified plans. Specifically, they must satisfy the requirements of Code §401(a)(4), (5) and (26), as well as Code §410(b).[35] Thus, one of three tests must be satisfied: (1) a percentage test, (2) a ratio test, or (3) an average benefits test.[36]

---

[26] Act §1105. Code §402(g)(8).
[27] Act §1105(b) adding Code §6051(a)(8).
[28] Act §1105(c)(1).
[29] Act §1105(c)(2).
[30] Act §1105(c)(2).
[31] Act §1120(a).

[32] Act §1120(b) adding Code §403(b)(10). The term "church" includes: (1) a convention or association of churches, and (2) an elementary or secondary school that is controlled, operated, or principally supported by a church or by a convention or association of churches. The term "qualified church-controlled organization" means any church-controlled tax-exempt organization described in Code §501(c)(3) other than an organization that both (1) offers goods, services, or facilities for sale to the general public other than goods, services, or facilities that are sold at a nominal charge which is substantially less than the cost of providing such goods, services, or facilities, and, also, (2) normally receives more than 25% of its support from governmental sources or receipts for admissions, sales of merchandise, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses (House Report, p. 716). As a result, the tax-sheltered annuity nondiscrimination rules do not apply to the typical seminary, religious retreat center, or burial society, regardless of their funding sources, because they do not offer goods, services, or facilities for sale to the general public. Similarly, the rules do not apply to a church-run orphanage or old-age home, even if it is open to the general public, if not more than 25% of its support was derived from the receipts of admissions, sales of merchandise, performance of services, or furnishing of facilities (in other than unrelated trades or businesses) or from governmental sources. The House Report, however, indicates that it is specifically intended that the coverage and nondiscrimination rules are to apply to church-run universities (other than religious seminaries) and hospitals if both conditions (1) and (2) above exist. Auxiliary organizations of a church (including youth groups, women's auxiliaries, etc.) generally would satisfy neither of the conditions and thus, the coverage and nondiscrimination rules would not apply. Similarly, these rules generally do not apply to tax-sheltered annuity programs maintained by church pension boards or fund-raising organizations (House Report, p. 716).
[33] Act §1120(b). Code §403(b)(10)(A)(ii).
[34] Act §1120(b). Code §403(b)(10).
[35] Act §1120(b) adding Code §403(b)(10). Code §403(b)(10)(A)(i).
[36] Act §1112(b). Code §410(b). The Conference Report clarifies that, in applying the average benefits test, elective deferrals under a tax-sheltered annuity are to be disregarded (Conf. Rep., p. II-420).

In general, the nondiscrimination rules apply in the same manner to tax-sheltered annuity programs as they do to qualified plans. Thus, the full array of rules relating to nondiscrimination apply (for example, the $200,000 limit on the amount of compensation that may be taken into account, the special nondiscrimination rules applicable to matching contributions, the employee leasing rules and the minimum participation rules are applicable for purposes of testing whether non-elective contributions to a tax-sheltered annuity plan are discriminatory).[37]

b. Integration

Employers that maintain tax-sheltered annuity programs may integrate contributions or benefits under the post-1986 TRA integration rules: (1) for purposes of the average benefits test (Code §410(b)), (2) to establish comparability between programs (or between a program and a plan), and (3) for satisfying the benefits test within a plan (Code §401(a)(4)). The Conference Report, however, directs that the Secretary may not prescribe rules that permit disparity under the post-1986 TRA integration rules for employees who are not covered by Social Security. [38]

c. Aggregation of Plans

If a tax-sheltered annuity program, standing alone, fails to satisfy the percentage test, the ratio test, or the classification test under the post-1986 TRA nondiscrimination and coverage rules generally applicable to qualified plans, the employer may elect to treat the tax-sheltered annuity program and a qualified plan or another tax-sheltered annuity program as a single plan, solely for purposes of demonstrating that the tax-sheltered annuity program satisfies the coverage requirements. If the employer does this, for purposes of satisfying the coverage rules, the plans that are aggregated with the tax-sheltered annuity also must provide contributions or benefits that do not discriminate in favor of highly compensated employees. [39]

The requirement that aggregated arrangements provide comparable contributions or benefits generally applies in the same manner to tax-sheltered annuity programs as it does to qualified plans. Thus, the Conference Report indicates that the principles of Rev. Rul. 81-202, as modified by the Act for qualified plans in general, are to apply to tax-sheltered annuities. [40] The Conference Report directs the Secretary, however, to prescribe rules for tax-sheltered annuities that reduce the administrative burden of applying Rev. Rul. 81-202. For example, testing less frequently than annually may be permitted. [41]

The Conference Report also indicates that, in applying the average benefit percentage component of the average benefits test to a tax-sheltered annuity program, an employer may, at its election, include all qualified plans in determining the average benefit percentages. A tax-sheltered annuity program, however, may not be aggregated with a qualified plan for purposes of determining whether the qualified plan satisfies the applicable nondiscriminatory coverage rules, including the average benefits test. [42]

d. Excludable Employees

In general, the categories of employees that are excludable in applying the coverage and nondiscrimination rules to tax-sheltered annuities are the same as those excludable for purposes of qualified plans, except that, in addition, an employer may exclude from consideration students who normally work less than 20 hours a week. The Conference Report indicates, however, that the 20-hour requirement only applies if the employer excludes all students normally working less than 20 hours per week. [43]

e. Aggregation Based on Line of Business

The general rules regarding aggregation of employers and testing on a line of business or operating unit basis, are to apply to tax-sheltered annuities under rules prescribed by the Secretary. [44] The Secretary, however, may provide a special, narrower definition of employer for purposes of the rules applicable to elective deferrals under tax-sheltered annuity plans. [45]

C. Constructive Receipt

The Act specifically provides that the amount actually distributed to any distributee under a tax-sheltered annuity contract is taxable to the distributee in the year in which it is distributed under Code §72. [46] In effect, the Act makes the doctrine of constructive receipt inapplicable to tax-sheltered annuities. As a result, the determination of the year in which the taxation of distributions from tax-sheltered annuities occurs has been placed on an equivalent basis with distributions from qualified plans in general.

Note: The constructive receipt rules, however, apply to nonqualified annuities.

This provision applies to taxable years beginning after December 31, 1985. [47]

---

[37] Conf. Rep., p. II-418-419.
[38] Conf. Rep., p. II-419.
[39] Conf. Rep., p. II-419.
[40] Conf. Rep., p. II-419. Rev. Rul 81-202 sets forth the procedure for aggregating qualified plans. The discussion describing the Act's modification to Rev. Rul. 81-202 is at Conf. Rep., p. II-413.
[41] Conf. Rep., p. II-419.
[42] Conf. Rep., p. II-419.
[43] Conf. Rep., p. II-420.
[44] Conf. Rep., p. II-420.
[45] Conf. Rep., p. II-420.
[46] Act §1122(d)(2) amending Code §403(b)(1) by adding a new sentence concerning the taxation of the distribution to the distributee.
[47] Act §1122(h)(7).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 57

TREATMENT OF DISTRIBUTIONS

Diane J. Fuchs, Esq.
Silverstein and Mullens
Washington, D.C.

I. Minimum Distribution Requirements

A. Introduction

The Internal Revenue Code contains minimum distribution rules respecting qualified plans which govern both before-death and after-death distributions. The Code also provides before- and after-death minimum distribution rules for IRAs.

1. Pre-Act Before-Death Distribution Rules

The qualification of a pension plan depends on the plan satisfying certain rules concerning both the mandatory commencement, and the minimum amount, of distributions. A qualified plan must provide that the entire interest of each participant will be distributed no later than the participant's required beginning date.[1] Alternatively, the distribution may be made in substantially non-increasing annual payments which must begin no later than the participant's required beginning date, and be paid out over (1) the life of the participant; (2) the lives of the participant and the designated beneficiary; (3) a period (which may be a term certain) not extending beyond the life expectancy of the participant; or (4) a period (which may be a term certain) not extending beyond the life expectancies of the participant and the designated beneficiary.[2]

For both purposes, the required beginning date is generally April 1 of the calendar year following the calendar year in which either the participant attains age 70½ or retires, whichever is later. Under pre-1986 TRA law, the required beginning date for a 5% owner was April 1 of the calendar year following the calendar year in which the participant attained age 70½, even if the participant had not retired.[3]

Another requirement for before-death distributions, known as the "incidental benefits rule," is that the plan must provide for a form of distribution whereby the present value of projected payments to the participant, while living, is more than 50% of the present value of total payments projected to be made to the participant and his or her beneficiaries. Where a distribution option satisfies the requirements for joint and survivor annuities, however, it need not satisfy the incidental benefits rule.

The before- and after-death distribution rules applicable to qualified plans under pre-1986 TRA law also applied to tax-sheltered annuities under Code §403(b).[4] After the amendments to Code §408 made by the 1984 Tax Reform Act, the before- and after-death minimum distribution rules for IRAs have corresponded to the rules for qualified plans with the exception that distributions must commence from an IRA by April 1 of the calendar year following the year in which the IRA owner attained age 70½ regardless of the date of the IRA owner's separation from service.[5]

2. After-Death Distributions

The Code also contains minimum distribution requirements that govern distributions from qualified plans where a participant has died. The applicable rules depend on whether benefits commence before or after the participant's death.[6]

If a participant dies after the commencement of benefit payments, the remaining portion of the participant's interest must be distributed at least as rapidly as under the distribution method that was in effect prior to death. Where no distributions commenced before death, the participant's entire interest must, in general, be distributed within five years of the date of death. This rule is subject to two exceptions.[7] First, the five-year rule does not apply to that portion of a participant's after-death remaining interest payable to a designated beneficiary over the beneficiary's life (or over a period not extending beyond his or her life expectancy) if the distributions commence no later than one year after the date of death and are paid to the beneficiary under rules that meet the same minimum distribution requirements that apply to before-death distributions.[8] The second exception to the five-year requirement is where the designated beneficiary is the participant's surviving spouse.[9]

---

[1] Code §401(a)(9). Unless otherwise specified, all section references are to the 1986 Internal Revenue Code.
[2] Code §401(a)(9).
[3] Code §§401(a)(9)(C) and 416(i).
[4] *See* Technical Corrections provisions of House bill. *See also* H.R. Rep. 841, 99th Cong., 2d Sess., p. II-449 (1986)("Conference Report").
[5] Code §408(a)(6).
[6] Code §401(a)(9)(B) and (C).
[7] Code §401(a)(9)(B)(ii) and (iii).
[8] Code §401(a)(9)(B)(iii).
[9] Code §401(a)(9)(B)(iv).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

3. Rationale for Change

The 1986 TRA changes make the rules concerning the required beginning date for distributions uniform for all qualified plans and eliminate the disparities that exist, for example, in the distribution requirements for IRAs and for other qualified plans, as well as the disparities that exist between participants who are and are not 5% owners.[10] The legislative history also indicates that Congress believed that it was easing the administrative burdens in both the public and private sectors by eliminating the need for a subjective task to determine when withdrawals are required to begin, since, under pre-1986 TRA law, the time of separation from service was sometimes difficult to determine.[11] In imposing uniform minimum distribution rules with respect to the permissible periods over which benefits from any tax-favored retirement arrangement may be distributed, Congress was endeavoring to ensure that tax-favored retirement plans would be used to replace a participant's pre-retirement income stream at retirement, rather than for the indefinite deferral of tax on a participant's accumulation under the plan.[12]

In applying an excise tax for violations of the minimum distribution rules, Congress sought to avoid the sanction of disqualification which, it believed, was too onerous for a plan's failure to satisfy the highly technical distribution requirements with respect to any one participant. This is especially significant in light of the fact that plan administration is generally outside the control of most participants and a particular failure may have occurred with respect to one participant. Thus, while a plan should, by its terms, prohibit the violation of the minimum distribution rules, the legislative history indicates that an excise tax was the remedy chosen because Congress believed that such an operational error should not cause plan disqualification.[13]

B. Overview

The Tax Reform Act of 1986 extends the commencement of distribution rules previously applicable only to 5% owners and IRA participants to all participants in tax-favored retirement arrangements including qualified plans, IRAs, tax-sheltered annuities and custodial accounts. Thus, distributions from all qualified plans must commence no later than April 1 of the calendar year following the year in which the employee reaches age 70½, regardless of whether the employee retires.[14]

The Act also imposes an excise tax on amounts that were required to have been distributed during the taxable year under Code §§401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3) or 457(d)(2), but which were not distributed. The tax is equal to 50% of the amount by which the minimum required distribution exceeds the actual amount distributed during the taxable year. The tax, which the Secretary of the Treasury may waive under certain circumstances, must be paid by the participant (or, if relevant, the beneficiaries of the estate.[15]

These provisions, in general, apply to years beginning after December 31, 1988. There are special rules with regard to plans maintained pursuant to collective bargaining agreements. There is also a transitional rule for 5% owners and an exemption for benefits with respect to which a designation was made under §242(b)(2) of the Tax Equity and Fiscal Responsibility Act of 1982.[16]

C. Detailed Analysis

1. Uniform Required Beginning Date

The Act revises the required beginning date rules in Code §401(a)(9)(C) to prohibit distributions that commence after the April 1 of the calendar year following the calendar year in which an employee attains age 70½.[17]

Distributions from all tax-favored retirement arrangements including plans of state and local governments and tax-exempt under Code §457, are subject to the 1986 TRA benefit commencement date rules. While in general, this provision is effective for years beginning after December 31, 1988. The Act contains a grandfather provision for individuals who attain age 70½ before January 1, 1988.[18] The grandfather rule, however, contains an exception. It does not protect 5% owners (as defined in §416(i)) at any time during the plan year ending with or within the calendar year in which the owner reaches age 66½ or any subsequent year.[19]

2. Excise Tax for Failure to Make Minimum Required Distributions

The Act imposes a 50% excise tax on the person receiving a distribution if the distribution is less than the required minimum distribution amount for the year.[20] The excise tax is applied to the amount by which the minimum required distribution exceeds the actual amount distributed during the taxable year.[21]

The excise tax applies to distributions during the taxable year from plans qualified under Code §401(a); from annuity plans and contracts described in Code §403(a) and (b), from IRAs and individual retirement annuities and from deferred compensation plans covered by Code §457.[22]

The Act does not specifically define the term "minimum required distribution." Rather, the Treasury Secretary is granted the authority to define the concept in regulations.[23]

The Conference Report sets forth guidelines to be followed by the Secretary in drafting these regulations. In general, it is intended that if a participant selects a permissible distribution option, the minimum required distribution in any year will be the amount required to be distributed in

[10] H.R. Rep. 426, 99th Cong., 1st Sess., p. 725 (1985).("House Report").
[11] House Report, p. 725. The example in the legislative history is the case of employees who cease their regular duties, but continue to work in connection with consulting agreements in order to postpone the commencement of benefit payments.
[12] House Report, p. 726.
[13] House Report, p. 726.
[14] Act §1121(b). Code §401(a)(9)(C).
[15] Act §1121(a). Code §4974.
[16] Act §1121(d).
[17] Act §1121(b) amending Code §401(a)(9)(C).
[18] Act §1121(d)(4)(B)(i).
[19] Act §1121(d)(4)(B)(ii).
[20] Act §1121(a)(1). Code §4974.
[21] Act §1121(a)(1). Code §4974(a).
[22] Act §1121(a)(1). Code §4974(c).
[23] Act §1121(a)(1). Code §4974(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

that year under the payout option selected. First, the Conference Report states that, with respect to a defined contribution plan, the minimum required distribution must be determined as under pre-1987 law.[24] With respect to a defined benefit plan, the Conference Report requires that, if the participant selects an impermissible payout option and designates a beneficiary, the minimum required distribution in any year is the amount that would have been distributable to the participant in that year had the participant selected a joint and survivor annuity payable over the joint life and last survivor expectancies of the participant and the designated beneficiary. The actual ages of the beneficiary and the participant at the required beginning date must be taken into account. For this purpose, the survivor benefit is assumed to be the maximum percentage of the annuity payable during the participant's lifetime that will not violate the incidental benefit rule, but may not be more than 100% of the benefit payable to the participant.[25] The Conference Report provides that even if the distribution option is described in the plan and the plan receives a favorable determination letter, the excise tax will still apply.[26]

Where the participant selects an impermissible payout option and does not designate a beneficiary, the minimum required distribution in any year will be the amount that would have been distributable to the participant in that year had the participant selected an annuity payable over the participant's life expectancy, taking into account the participant's actual age on the required beginning date.[27]

The tax is imposed on the recipient of the distribution. The Secretary is permitted, in certain circumstances, to waive the excise tax for any taxable year. For the Secretary to do so, the taxpayer must establish to the secretary's satisfaction that the shortfall in the amount distributed was due to reasonable error and that reasonable steps are being taken to remedy the shortfall.

3. Effective Date

In general, the provisions concerning the excise tax for failure to satisfy the minimum distribution requirements apply to years beginning after December 31, 1988.[28]

The Act contains an exception, however, for distributions that are made to an employee in accordance with a benefit designation made before January 1, 1984, by the employee in accordance with §242(b)(2) of the Tax Equity and Fiscal Responsibility Act of 1982.[29]

Note: TEFRA amended §401(a)(9) to conform the distribution rules for distributions from qualified plans to those then applicable to Keogh plans or H.R. 10 plans. Thus, TEFRA applied the age 70½ distribution rule, for the first time to qualified plans.[30] TEFRA, however, contained a special transitional rule which exempted certain distributions made pursuant to employee designations made before January 1, 1984. Thus, if designations were made under the terms of a plan before January 1, 1984, to commence distribution after age 70½, provided the method of distribution satisfied the distribution rules in effect prior to TEFRA, such designations were protected by TEFRA without regard to the date that the distributions commence.[31] This protection continues notwithstanding the amendments made by Tax Act §1121 concerning the minimum distribution requirements.[32]

Special effective date rules apply to plans maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers if the agreements were ratified before March 1, 1986. In that case, the 1986 TRA 50% excise tax does not apply to distributions made to individuals covered by the agreements in plan years beginning before the earlier of either (1) the later of the date on which the last of the collective bargaining agreement terminates, or January 1, 1989; or (2) January 1, 1991.

II. Taxation of Distributions

A. Introduction

In general, distributions from qualified plans and IRAs are includable in gross income in the year in which the distribution is made. An individual may elect to receive favorable tax treatment on a lump-sum distribution provided certain requirements are satisfied. In general, under pre-1986 TRA law, the portion of a lump-sum distribution from a qualified plan that was attributable to a participant's post-1973 service qualified for 10-year forward averaging and, the portion of such a distribution that was attributable to pre-1974 service was eligible for long-term capital gains treatment.

Pre-TRA law also contained special rules for the treatment of basis where an individual received a distribution from a qualified plan, IRA, or tax-sheltered annuity. Such basis was generated from employee contributions. If an amount was received before the annuity starting date, the individual was treated as first receiving employee contributions, which were non-taxable, and only when such basis was used up, as receiving taxable income. With regard to amounts received after the annuity starting date in the form of an annuity, under pre-1986 TRA law, each payment received by the employee was generally treated, in part, as a return of the employee's contributions, and, in part, as taxable income. The portion of each payment that was treated as a return of employee contributions was that amount which bore the same ratio to each payment as the employee's total compensation bore to his total expected payments over the period of the annuity. In the case of a straight-life annuity, the employee's life expectancy, as of his annuity starting date, was treated as the period over which the annuity would be paid for purposes of computing the total expected return under the contract. If the employee died prior to the expiration of his anticipated life expectancy, no deduction was provided for the employee's

[24] Conference Report, p. II-451.
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] Act §1121(d)(1).
[29] Act §1121(d)(4)(A).
[30] TEFRA §242(a).
[31] TEFRA §242(b)(2).
[32] Act §1121(d)(4).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

unrecovered basis. Conversely, where the employee's life was longer than that which was anticipated at the time his benefits started, pre-1986 TRA law effectively excluded from income the amount in excess of the employee's total contributions (by continuing to apply the same exclusion ratio to all payments under the contract).

Under pre-TRA law, there was also a special rule for annuity payments from qualified plans where payments to the individual in the first three years equalled or exceeded the individual's aggregate employee contributions. In that situation, all distributions were treated as a return of employee contributions and were non-taxable, until all of the individual's employee contributions were recovered. After that, the distributions were fully taxable.

The 1986 TRA changes to the taxation of distribution rules reflect Congress' concern that the pre-TRA rules were inconsistent with the policy of providing individuals with income at retirement rather than during their working lives.[33] Congress also determined that the rules permitting individuals to rollover distributions into IRAs, thereby avoiding taxation until retirement age, effectively served to carry out the original purpose of the capital gains and 10-year averaging provisions. That is, the availability of rollovers mitigates the effect of a progressive tax structure on individuals receiving all of their benefits in a single year. Since amounts that are rolled over to a qualified recipient plan are taxed only as the amounts are withdrawn from the IRA, amounts distributed from tax-qualified plans and rolled over can be protected from taxation until the employee receives distributions from the recipient plan. In many cases, the employee will be in a lower tax bracket when this occurs. The tax results that will occur under the post-1986 TRA individual rates will similarly tend to effectuate this policy goal. As under pre-TRA law, rollovers will be available as a planning tool for qualifying distributions. Further, under the post-TRA individual rates, which provide for a fairly flat rate structure, the chances of an individual being in a substantially higher bracket in the year he or she receives a distribution are minimized. Given the post-TRA rate structure (*i.e.*, a decreased need for income averaging), Congress determined that 10-year averaging should be reduced to five-year averaging and that capital gains treatment should only be available on a very limited basis.[34]

Similarly, Congress felt that the pre-1986 TRA basis recovery rules for early distributions permitted the accelerated tax-free recovery of employee contributions and thereby encouraged the use of tax-favored plans for nonretirement purposes. Congress also believed that the three-year basis recovery rule provided favorable treatment to a very limited number of taxpayers and was inequitable with respect to others.[35]

B. *Overview*

The 1986 TRA modifies the rules governing the taxation of distributions from qualified plans in several significant respects. First, the Act eliminates 10-year forward averaging for lump-sum distributions in favor of five-year forward averaging. Ten-year forward averaging, however, is preserved for certain grandfathered individuals.[36]

Second, the Act phases out the capital gains treatment for distributions attributable to pre-1974 participation over a six-year period. Again certain grandfathering rules are provided.[37]

Third, the Act modifies pre-TRA law concerning the order of recovery of employee contributions and repeals the three-year basis recovery rule.[38] The 1986 TRA ordering rules make after-tax employee contributions less attractive.

Fourth, the Act provides special basis recovery rules for distributions from an IRA to which nondeductible contributions were made.[39] Under the TRA rules, the revised general basis recovery provisions are extended to IRAs. In addition, all IRAs of an individual are treated as a single contract and all distributions during a taxable year are treated as a single distribution.[40]

C. *Detailed Analysis*

1. *Elimination of 10-Year Forward Averaging*

The Act eliminates 10-year forward averaging for lump-sum distributions, replacing it with a provision that permits one-time five-year forward averaging for after age 59½.[41] Thus, special averaging for lump sum distributions before age 59½ is no longer permitted, except if the individual qualifies under a special "grandfather" rule discussed below. The five-year forward averaging is calculated in a similar manner as was used under pre-TRA law with respect to 10-year forward averaging.[42]

In general, the 1986 TRA averaging provisions apply to distributions received after December 31, 1986.[43] The Act provides an elective transition rule for individuals who attained age 50 before January 1, 1986.[44] Under this rule, a qualified individual may make a one-time election at any age with respect to a single lump sum distribution to use either 10-year forward averaging under pre-1986 TRA tax rates, or five-year averaging under the revised rates.[45] Not more than one election may be made under this transition rule with respect to any lump-sum distribution payable to that employee.[46] Thus, the election is in lieu of, and not in addition to, the single post-age 59½ election to claim five-year forward averaging under the post-TRA rules.[47]

Note: The statute provides a special rule for those who separate from service in 1986 and receive a lump sum distribution after December 31, 1986, and before March 16, 1987. Such individuals will be permitted to elect lump-

[33] S. Rep. 313, 99th Cong., 2d Sess., p. 608 (1986).("Senate Report").
[34] Senate Report, page 609.
[35] *Id.*

[36] Act §1122(a). Code §§402(e)(4)(B) and 402(e)(1)(C).
[37] Act §1122(b). Code §§402(a)(2) and 403(a)(2).
[38] Act §1122(c). Code §72(b), (d) and (e).
[39] Act §1102(c). Code §408(d)(2).
[40] Act §1102(c)(2).
[41] Act §1122(a)(1). Code §402(e)(4)(B) (relating to election of lump-sum treatment) and Act §1122(a)(2). Code §402(e)(1)(C) (relating to initial separate tax).
[42] The amendments to Code §402(e) did not change the averaging formula, except to replace 10% with 5%.
[43] Act §1122(h)(1).
[44] Act §1122(h)(3)(C).
[45] Act §1122(h)(3) and (h)(5).
[46] Act §1122(h)(3)(C).
[47] Act §1122(h)(3)(C).

sum treatment for their distribution as if the distribution were received on the date the employee separated from service.[48]

2. Pre-1974 Capital Gains Treatment

The Act repeals the provisions of pre-TRA law permitting capital gains treatment for the portion of a lump sum distribution attributable to pre-1974 participation.[49]

Effective for distributions received after December 31, 1986, if a participant makes an election, the pre-TRA law's long-term capital gains treatment for the part of a lump sum distribution attributable to pre-1974 participation will apply, but will phase out on a percentage basis over a six-year period.[50] The phase-out schedule is as follows:

For Distributions During Calendar Year	*The Phase-Out Percentage Is*
1987	100
1988	95
1989	75
1990	50
1991	25

Thus, for example, in 1988, if a participant elects capital gains treatment, 95% of a distribution attributable to pre-1974 participation will be eligible for capital gains treatment.

Note: If an election is made for capital gains treatment, the statute precludes a future election of five-year forward averaging with respect to distributions from qualified plans in which the employee participates. Further, although it is not entirely clear, the election of capital gains phase-out treatment will likely involve a 28% rate rather than the flat 20% rate prescribed for purposes of the grandfather rule (see discussion below).

The capital gains provisions also contain a transition rule. Individuals who attained age 50 on or before January 1, 1986, may make an election under the transition rule to have a flat capital gains effective rate of 20% apply to the pre-1974 portion of the lump sum distribution.[51] This 20% rate applies to all electing grandfathered individuals, regardless of the maximum effective capital gains rate of the taxpayer under pre-TRA law.[52] Only one such election, however, may be made under the transitional rule. Thus, if the election is made before the participant reaches age 59½, no further elections may be made after he or she attains age 59½.[53]

3. Basis Recovery Rules

In general, effective for distributions from qualified plans and tax-sheltered annuities made after December 31, 1986, the Act imposes uniform basis recovery rules applicable for both pre- and post-annuity starting date distributions.

For these purposes, as under pre-TRA law, basis is determined separately with respect to each "contract" from which a distribution is being made.

a. Pre-Annuity Starting Date Distributions

(1) In General

In general, the Act modifies the basis recovery rules for pre-annuity starting date distributions to provide for the pro rata recovery of employee contributions from qualified plans and tax-sheltered annuities. As a result, such distributions are no longer treated as first coming from after-tax employee contributions.[54] The portion of each pre-annuity starting date distribution that may be excluded is that portion of the payment that bears the same ratio to the total payment as the participant's after-tax employee contributions (and amounts treated as after-tax employee contributions) bear to the total value of the participant's accrued benefit (or account balance) under the plan as of the date of distribution or as of such other time as the Secretary prescribes in regulations.[55] The Secretary is authorized to prescribe appropriate rules for estimating the amounts that are included and excluded where precise calculation would present an unjustifiable burden for the taxpayer.[56]

Note: If an employee is partially vested in employer contributions, the nonvested portion of the employee's accrued benefit is not included for purposes of determining the total value of the employee's accrued benefit.[57]

Where a distribution is made from a defined contribution plan or a separate account of a defined benefit plan, amounts distributed that are attributable to employee contributions (and earnings thereon) will be treated as a separate contract for purposes of applying the pro rata formula.[58] As a result, if an employee withdraws employee contributions from a plan, no part of the distribution will be considered attributable to employer contributions. The distribution will be partially non-taxable, *i.e.*, a return of employee contributions, and partially taxable, *i.e.*, a distribution of earnings on those contributions. Further, if an employee withdraws all amounts attributable to employee contributions and the amount is less than the employee's contributions, the employee may recognize a loss.[59]

Comment: Regulations may provide that, in general, employees will be able to withdraw amounts attributable to their employee contributions in whichever order they choose relative to employer contributions. The author understands that the Service may elect not to impose an ordering rule but rather might permit a retired employee to first withdraw amounts attributable to employee contributions before beginning the withdrawal of amounts attributable to employer contributions.

[48] Act §1124(a).
[49] Act §1122(b)(1). Specifically, the Act repeals Code §402(a)(2) (relating to capital gains treatment for a portion of lump sum distribution) and Code §403(a)(2) (relating to capital gains treatment for certain distributions from annuity contracts) and makes various technical corrections implementing the repeal.
[50] Act §1122(h)(4).
[51] Act §1122(h)(3) and (h)(6).
[52] Conference Report, p. II-462.
[53] Act §1122(h)(4)(C).
[54] Act §1122(c)(3). Code §72(e)(8), (9).
[55] Act §1122(c)(3). Code §72(e)(8).
[56] Senate Report, p. 610.
[57] *Id.*
[58] Act §1122(c). Code §72(e)(9).
[59] See Conference Report, p. II-462.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Query: How will the post-TRA pro rata rules be applied for purposes of net unrealized appreciation in employer securities. For example, if an employee withdraws all the funds in his employee account under the rule requiring a pro rata inclusion in income, it is unclear, with regard to appreciated employer securities, whether a basis adjustment would have to be made in the amount withdrawn from the employee's stock account, or whether the employee would be permitted to withdraw the amount in the employee's stock account without income tax liability.

(2) Transition Rule

The Act provides special relief from the post-TRA proration rules for certain distributions. In the case of a plan, which on May 5, 1986, permitted withdrawals before the occurrence of a separation from service, the TRA proration rules apply only to the extent that the amounts received before the annuity starting date (increased by amounts previously received under the contract after December 31, 1986) exceed the investment in the contract as of December 31, 1986.[60] The effect of the transition rule is to retain pre-TRA law basis recovery for amounts accrued as of December 31, 1986, in plans which, as of May 5, 1986, permitted in-service distributions.

It is not clear from the statute whether income earned before December 31, 1986, on employee contributions accrued as of December 31, 1986, is to be treated as part of the protected amounts, or whether such income is to be added to the post-1986 contract subject to the post-TRA proration rules.[61]

Comment: Another issue is how amounts earned on pre-1987 contributions are to be calculated. Many employers do not maintain adequate records for making such a determination. Those responsible for drafting regulations in this area are considering allowing employers to specifically account for such earnings, or to arbitrarily calculate the earnings by using an artificially determined earnings rate, which may be established by regulation.

b. Elimination of Three-Year Basis Recovery Rule

Among the most controversial provisions in the Act, due to its retroactive application and its primary impact on federal, state and local government employees (who typically participate in plans to which they make after-tax contributions), is the provision repealing the three-year basis recovery rule.[62] The repeal is effective with respect to any individual whose annuity starting date is after July 1 1986.[63]

c. Post-Annuity Starting Date Distributions

With the repeal of the three-year basis recovery rule, the exclusion ratio rules for annuity payments under pre-TRA law become applicable to all distributions received in annuity form. Thus, all post-annuity starting date distributions are treated as if a portion is attributable to after-tax employee contributions (and therefore excludable) and a portion is attributable to employer contributions (and therefore taxable).[64] The excludable amount of each payment is the amount that bears the same ratio to each payment as the total employee contributions ("investment in the contract") bear to the total expected payments over the period of the annuity.[65]

The Act limits, however, the total amount that an employee may exclude from income to the total amount of the employee's contributions.[66] Once the total amount of after-tax employee contributions have been excluded, annuity payments become fully taxable.[67]

On the other hand, if annuity payments cease before the employee's entire investment in the contract is recovered under the exclusion ratio provisions, unrecovered amounts are allowed as a deduction. Specifically, if, after the annuity starting date, the payments cease by reason of the death of the annuitant and, as of the date of the cessation, there is unrecovered investment [68] in the contract, then the amount of the unrecovered investment is allowed as a deduction to the annuitant for his last taxable year. Where the annuity contract provides for payments to a beneficiary or to the estate of the annuitant, and the payments are in the nature of a refund of the consideration paid, then the deduction is allowed to the beneficiary or the estate.[69] In general, this rule will be particularly helpful where an employee has a large basis in the annuity contract and dies earlier than his life expectancy.

Note: For purposes of Code §172 (concerning the net operating loss deduction), the deduction for the unrecovered investment in the contract is treated as if it were attributable to a trade or business of the taxpayer.[70]

The Act does not revise pre-TRA law with respect to distributions that are not received in the form of an annuity and that are paid after the annuity starting date. As under pre-TRA law, such amounts are deemed to be attributable first to income on the contract.[71]

Note: The separate contract rules with regard to after-tax employee contributions also apply to post-annuity starting date distributions.[72]

d. IRA Basis Rules

In general, effective for distributions occurring after December 31, 1986, amounts distributed from an IRA are included in the gross income of the payee or distributee in the manner prescribed for qualified plans and tax-sheltered annuities under Code §72, as amended by the Act.

---

[60] Act §1122(c)(3)(A). Code §72(e)(8)(D).

[61] For a discussion of this issue, *see* letter to Harry Conaway, Acting Associate Tax Legislative Counsel, U.S. Department of Treasury, from John M. Vine, dated November 10, 1986, concerning §1122(c)(3) of the Tax Reform Act of 1986.

[62] Act §1122(c)(1), repealing Code §72(d).

[63] Act §1122(h)(2)(A).

[64] Act §1122(c)(2). Code §72(b)(1).

[65] Act §1122(c)(2). Code §72(b)(1).

[66] Act §1122(c)(2). Code §72(b)(2).

[67] Act §1122(c)(2). Code §72(b)(2).

[68] Unrecovered investment for these purposes is treated as the investment in the contract as of the annuity starting date, reduced by the aggregate amount received under the contract on or after the annuity starting date and before the date as of which the determination is being made, to the extent that the amount was excludable from gross income. Act §1122(c)(2). Code §72(b)(4).

[69] Act §1122(c)(2). Code §72(b)(3)(B).

[70] Act §1122(c)(2). Code §72(b)(3)(C).

[71] Senate Report, p. 610.

[72] Conference Report, p. II-462.

In addition, there are special rules for IRAs. First, all IRAs of a particular individual are treated as one contract. Second, all distributions during any taxable year are treated as one distribution. Third, the value of the contract, income on the contract and investment in the contract are computed as of the close of the calendar year with or within which the taxable year of the individual ends.[73] The value of the contract for these purposes must be calculated by adding back any distributions made during the calendar year.[74]

Note: If amounts are withdrawn from an IRA during a taxable year, and the individual has previously made both deductible and nondeductible IRA contributions, the amount includable as income for the taxable year, is the portion of the amount withdrawn that bears the same ratio to the amount withdrawn for the taxable year as the individual's aggregate nondeductible IRA contributions bear to the aggregate balance of all IRAs of the individual (including rollover IRAs and SEPs).[75]

Care should be exercised in rolling over distributions from qualified plans to IRAs. Because all IRAs are treated as a single contract, rollovers of qualified plan distributions (which do not include amounts attributable to employee contributions) will reduce IRA basis. As a result, trustee-to-trustee transfers are desirable and, where a new employer cannot be persuaded to accept such a transfer, the amounts should be rolled over to an IRA that holds only the qualified plan distribution and, which, at a later time, may be transferred to another qualified plan.

4. Special Treatment for Rollover Distributions

a. Partial Rollovers

Under pre-TRA law, a partial distribution could be rolled over to an individual retirement account provided: (1) the employee made an election for the rollover, (2) the distribution was at least equal to 50% of the balance to the credit of the employee, and (3) the distribution was not one of a series of periodic payments.[76] To prevent the avoidance of the 1986 TRA basis recovery rules, the Act limited the rollovers of partial distributions by eliminating in-service rollovers. Under the Act, partial distributions may be rolled over only if the distribution is made pursuant to the same events that permit a lump-sum distribution under amended Code §402(e)(4)(A), that is, the death of the employee, separation of the employee from service (including the separation from service of a self-employed individual), or the employee's disability.[77] The Act repeals, however, the requirement that a partial distribution not be one of a series of periodic payments.[78]

The Act contains an exception from the revised partial rollover rules for distributions from ESOPs made in order to satisfy 1986 TRA diversification requirements under Code §401(a)(28). Such amounts may be rolled over even if the distribution does not otherwise qualify for rollover treatment. Presumably, a rollover is permitted even if the rollover amount does not constitute at least 50% of the balance to the credit of the employee.[79]

b. Extension of Rollover Period for Certain Frozen Deposits

The Act contains a rule to accommodate individuals who have deposited with bankrupt or insolvent savings institutions amounts that were to have been rolled over within the prescribed 60-day period. The provision permits amounts deposited in certain financially distressed financial institutions to be rolled over into an IRA or qualified plan notwithstanding that the rollover does not occur within 60 days of the date of the original distribution to the employee. In effect, under the rule, the 60-day period does not include periods while the deposit is frozen. Further, the individual has a minimum of 10 days after the release of the funds to complete the rollover.[80]

5. Repeal of Constructive Receipt for Qualified Annuities

Under pre-1986 TRA law, benefits with respect to tax-sheltered annuities under Code §403(b) were includable in income when paid or made available in accordance with the constructive receipt rules.[81] The Act repeals the application of constructive receipt to tax-sheltered annuities. Owners of tax-sheltered annuities are, after the TRA, subject to tax only when benefits are actually received.[82] Note, however, that constructive receipt rules continue to apply to "non-qualified" annuities.[83] These rules apply retroactively for taxable years after December 31, 1985.

6. Net Unrealized Appreciation

The Act revises Code §402(e)(4)(J), which permits the exclusion from gross income of net unrealized appreciation attributable to securities of the employer. For distributions after December 31, 1986, to the extent provided in regulations, a taxpayer may elect, before any distribution, not to have this paragraph apply with respect to the distribution.[84]

7. Effective Dates

The basis recovery rules are generally effective for distributions made after December 31, 1986.[85] The repeal of the three-year basis recovery rule is effective with respect to individuals whose annuity starting date is after July 1, 1986.[86] The provision limiting the income exclusion to the amount of the employee's investment in the contract applies to individuals whose annuity starting date is after December 31, 1986.[87] The 1986 TRA rules concerning the rollover of partial distributions are effective with respect to amounts distributed after December 31, 1986.[88] The repeal of the constructive receipt rules for tax-sheltered annuities is applicable retroactively for taxable years after December 31,

[73] Act §1102(c). Code §408(d).
[74] Act §1102(c). Code §408(d)(2).
[75] Conference Report, p. II-379.
[76] Pre-1986 TRA Code §402(a)(5)(D).
[77] Act §1122(e). Code §402(a)(5)(D)(i).
[78] *Id.*
[79] *Id.*
[80] Act §1122(e)(2). Code §402(a)(6)(H) and §408(d)(3)(F).
[81] Code §403(b)(1).
[82] Act §1122(d)(2). Code §403(b)(1).
[83] Act §1122(d)(3). Code §403(c).
[84] Act §1122(g). Code §402(e)(4)(J).
[85] Act §1122(h)(1).
[86] Act §1122(h)(2)(A).
[87] Act §1122(h)(2)(B).
[88] Act §1122(h)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

1985.[89] The rule concerning frozen deposits is generally effective with respect to distributions after the date of enactment.[90]

D. Technical Corrections

1. Retirement Equity Act of 1984

a. Lump Sum Distributions

In determining whether a distribution payable due to separation from service is a lump sum distribution, the balance to the credit of the employee at the time of distribution does not include any increased vesting which could result from the participant's later reemployment.

The IRS is instructed to develop regulations indicating that, should a participant's reemployment prior to the expiration of five consecutive one-year breaks in service result in additional vesting for amounts accrued prior to the break, any reduction in taxes due to the reclassification of the distribution as a lump sum distribution (*i.e.*, due to the election of 10-year forward averaging or the special rules governing the treatment of net unrealized appreciation in employer securities) may be recaptured by the participant. Once such a recapture is made, the prior lump sum distribution elections will be disregarded and additional elections will be permitted.[91]

b. Rollovers

In determining whether a distribution made to an employee upon separation from service may be rolled over into another qualified plan or an Individual Retirement Account (IRA), the Technical Corrections provisions indicate that the balance to the credit of the employee will not include any increased vesting which could result from the participant's later reemployment.[92]

Generally, distributions received due to a separation from service are excluded from gross income if they are rolled over into a qualified plan or an IRA. If, however, participants elect rollover treatment and, due to their reemployment prior to the expiration of five consecutive one-year breaks in service, receive an increase in the vesting percentage applicable to amounts accrued prior to the separation, any subsequent distributions will be ineligible for 10-year forward averaging or capital gains treatment.

The provisions relating to the denial of ten-year forward averaging and capital gains treatment for subsequent distributions will be inapplicable where the initial distribution was made without the consent of the participant (*e.g.*, the amount distributed was not in excess of $3,500).

The Act clarifies the circumstances under which participants must be notified of their rollover options.[93]

In the event that a distribution made to a participant is eligible for rollover treatment under Code §402(a)(5), the recipient must be notified that the distribution will not be currently taxed if transferred into another qualified plan or an IRA and that, to qualify for tax-free rollover treatment, the transfer must be made within 60 days of receipt. Previously, this notification was only required if the distribution was a "qualifying rollover distribution," as defined in Code §402(a)(5)(E).

c. Qualified Pre-retirement Survivor Annuity

The Act clarifies the type of benefit payable to a participant's surviving spouse where the participant dies after separation from service or attainment of normal retirement age but prior to the annuity starting date or dies while receiving disability benefits under the plan. Although unclear in the original language of REA, a surviving spouse who dies after separation from service or attainment of normal retirement age, but prior to the annuity starting date, will be eligible to receive benefits in the form of a qualified pre-retirement survivor annuity.[94]

In determining the form of distribution applicable to surviving spouses of participants who died while receiving disability benefits, the definition of annuity starting date is amended to exclude the commencement of auxiliary disability benefits. For purposes of REA §§103 and 203, Code §417(c)(1)(A) and ERISA §205(e)(1), a disability benefit will be considered auxiliary if the participant receiving such benefit will, upon attainment of early or normal retirement age, receive a benefit which meets the vesting and accrual provision of Code §411. In light of this amended definition, the surviving spouse of a participant who had been receiving auxiliary disability benefits prior to attainment of early or normal retirement age will be entitled to receive benefits in the form of a qualified pre-retirement survivor annuity. Should such disability benefits not be auxiliary, however, the normal form of payment to the surviving spouse would be a qualified joint and survivor annuity.

The Act provides guidance in calculating the qualified pre-retirement survivor benefits payable under defined contribution plans.[95]

Qualified pre-retirement survivor annuities which are offered by defined contribution plans must be the actuarial equivalent of at least 50% of the participant's vested account balance as the date of death. Under prior law, this minimum payment was calculated based on the participants' entire account balance, whether vested or not.

For purposes of this section, a participant's vested accrued benefit will include amounts attributable to employee contributions. However, prior to the calculation of the qualified pre-retirement survivor annuity, the accrued benefit will be reduced by the amount of any security interest held by the plan with respect to an outstanding loan in default.[96]

Also, the Act clarifies the scope of the transitional qualified pre-retirement survivor annuity rules in cases where participants had named individuals other than their spouses as designated beneficiaries.[97]

---

[89] Act §1122(h)(7).
[90] Act §1122(h)(8).
[91] Act §1898(a)(2), amending REA §§102 and 202 and Code §402(e).
[92] Act §1898(a)(3), amending REA §§102 and 202 and Code §402(a)(6).
[93] Act §1898(e), amending REA §207 and Code §§402(f)(1) and (2).
[94] Act §1898(b)(1), amending REA §§103 and 203, Code §417(c)(1)(A) and ERISA §205(e)(1).
[95] Act §1898(b)(9), amending REA §§103 and 203, Code §417(c)(2) and ERISA §205(e)(2).
[96] Act §1898(b)(9), amending REA §§103 and 203, Code §417(c)(2) and ERISA §205(e)(2).
[97] Act §1898(h)(1), amending REA §§303(c) and 2503.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Benefits payable to the designated beneficiary of a participant who performs at least one hour of service under the plan after August 23, 1984 and dies before both the annuity starting date and the effective date of REA will be subject to the qualified pre-retirement survivor benefit transitional rules. Under this amendment, the present value of any amounts payable to the participant's surviving spouse under these transitional rules will be used to reduce the present value of any death benefits payable to the beneficiary of such participant. If the participant designates more than one beneficiary, the present value of the death benefit payable to each beneficiary will be reduced proportionately.

Spouses may waive their rights to receive the qualified pre-retirement survivor annuity, with certain restrictions. If the waiver is made on or before the end of the second plan year after the provisions of REA apply, it is not treated as a transfer of property subject to the gift tax, prohibited assignment or alienation provisions of the Code or ERISA. In addition, death benefits waived by surviving spouses will not be included in their gross income, but in the gross income of the recipients.

d. Plans to Which Survivor Pay-Out Rules Apply: Transferee Plans

The Act provides that, for purposes of determining whether a plan may be excluded from the survivor benefit requirements generally applicable to qualified pension plans, a plan will not be considered a transferee plan if such direct or indirect transfer of assets was completed before January 1, 1985.

Distributions on behalf of a participant in a profit sharing or stock bonus plan are excluded from the survivor benefit requirements generally applied to qualified plans if: the participant does not elect to receive benefits in the form of a life annuity; the plan provides that, in the event of the participant's death, all vested accrued benefits will be payable to the surviving spouse; and the plan is not a direct or indirect transferee of a plan under which survivor benefits were required.

In addition to providing the exclusion for transferee plans having completed their transfers prior to January 1, 1985, the Act provides that the rules with respect to transferee plans will only apply if the transferred assets (and the investment income attributable to same) are provided separate accounting. Should a participant's transferred assets not be given separate accounting, they, along with all other benefits payable on behalf of the participant, will be subject to the survivor benefit requirements.[98]

e. Qualified Joint and Survivor Annuity

The Act clarifies that the normal form of payment for participants who do not die prior to their annuity starting dates is a qualified joint and survivor annuity. Prior to this revision, participants were required to retire under the plan prior to their date of death in order to receive a qualified joint and survivor annuity as the normal form of payment.[99]

f. Waiver of Survivor Benefits

The Act expands the period during which participants must be notified of their right to waive the qualified pre-retirement survivor annuity.[100]

Under prior law, participants were given the opportunity to waive the qualified pre-retirement survivor annuity form of payment during the period beginning on the first day of the plan year in which they reached age 32 and ending at the end of the plan year preceding the plan year in which they reached age 35.

Under Act §1898(b)(5), however, this period is extended through the later of: 1) the end of the plan year in which the participant attains age 35; 2) a reasonable period of time after the individual becomes a participant; 3) a reasonable period of time after the survivor benefits applicable to the participant becomes unsubsidized; or 4) a reasonable period of time after the survivor benefits become applicable to a participant. Participants who separate from service prior to attaining age 35 must also receive this notice of election within a reasonable time following the separation.

Further, the Act provides that a spousal consent to waive the qualified joint and survivor or qualified pre-retirement survivor annuity will not be valid unless the waiver allows the spouse to name a designated beneficiary and limit the form of payment that such beneficiary will receive. If the spouse does not choose to name a designated beneficiary or limit the form of benefit payment, the waiver must acknowledge the spouse's right to name the beneficiary or limit the form of payment, and indicate that one or more of these rights have been voluntarily relinquished. This provision is effective for plan years beginning after the date of enactment of the 1986 TRA.[101]

g. Spousal Consent Election Period and Notice Requirements

The Act applies the spousal consent election period restrictions and notice requirements to situations involving immediate distributions.[102]

An immediate distribution of a qualified joint and survivor or qualified pre-retirement survivor annuity with a present value in excess of $3,500 is not permitted unless the participant and/or surviving spouse consents in writing to such receipt. Similarly, annuities having a present value of less than $3,500 cannot be immediately distributed after the annuity starting date without the consent of the participant and/or spouse.

A spousal consent to waive the qualified joint and survivor or qualified pre-retirement survivor annuity under such circumstances will not be valid unless it is made within the expanded election period under Act §1898(b)(5) and it

[98] Act §1898(b)(2), amending REA §§103 and 203, Code §§401(a)(11)(B) and 401(a)(11)(B)(iii)(III), and ERISA §§205(b)(1)(C)(iii) and 205(b)(1).

[99] Act §1898(b)(3), amending REA §§103 and 203, Code §401(a)(11)(A)(i) and ERISA §205(a)(1).

[100] Act §1898(b)(5), amending REA §§103 and 203, Code §417(a)(3)(B), and ERISA §205(c)(3)(B).

[101] Act §1898(b)(6), amending REA §§103 and 203, Code §417(a)(2)(A), and ERISA §205(c)(2)(A).

[102] Act §1898(b)(10), amending REA §§103 and 203, Code §417(f), and ERISA §205.

allows the spouse to name a designated beneficiary or limit the form of payment such beneficiary will receive.[103]

h. Annuity Starting Date Definition

The Act defines the term "annuity starting date," whether or not the amount is payable in the form of an annuity.[104]

Where benefits are payable in the form of an annuity, the annuity starting date is the first day of the first period in which the distribution is scheduled to commence, regardless of when, or if, the payment is actually made. Where benefits are not payable in the form of an annuity, the annuity starting date is the date on which the participant becomes entitled to a benefit due to the occurrence of certain events.

The annuity starting date for participants receiving disability benefits is the first day of the first period for which the benefit can be received, provided that the disability benefit is not auxiliary. A disability benefit will be considered auxiliary if the participant receiving such benefit will, upon attainment of early or normal retirement age, receive a benefit which meets the vesting and accrual provisions of Code §411.

i. Qualified Domestic Relations Orders

The Act provides that the qualified domestic relations order provisions only apply to plans which are subject to the assignment and alienation provisions of Code §401(a)(13). Under prior law, it was unclear whether the qualified domestic relations order provisions applied to governmental plans or other plans under Code §414(d) not subject to the assignment and alienation provisions.[105]

The Act also clarifies that the payment of benefits pursuant to a qualified domestic relations order does not constitute garnishment of wages for purposes of applying federal or state law garnishment restrictions.[106]

The Act provides that, in certain circumstances, the participant's former spouse will not be considered a spouse in applying the general provisions of the plan.[107]

A qualified domestic relations order may provide for the division of the participant's accrued benefits under a separation agreement, precluding the spouse's entitlement to additional survivor benefits under the plan's general survivor benefit provisions. In such case, the participant may elect to waive the payment of survivor benefits without obtaining spousal consent.

Also, the Act clarifies that a plan providing for the payment of benefits to an alternate payee under a qualified domestic relations order will not be disqualified under the provisions of Code §§401(a), (k) and 409(d). This rule will apply even if payments to the alternate payee are made with respect to a participant who has not separated from service and such payments commence before the participant reaches the earliest retirement age under the plan.[108]

Further, the Act revises the definition of "earliest retirement date" for purposes of applying the qualified domestic relations order provisions to both defined benefit and defined contribution plans.[109]

According to this revised definition, the "earliest retirement date" is the date on which the participant attains age 50 or becomes eligible to receive a distribution from the plan due to a separation from service (whichever is later) or, if earlier, the date on which benefits become payable to the participant under the plan.

j. Procedures for Disputed Payments Under QDROs

The Act refines the procedures under which disputed benefit payments are to be deferred by the plan administrator.[110]

Pending the determination of whether a domestic relations order is a qualified domestic relations order (QDRO), the administrator is instructed to defer the payment of any benefits in dispute. While it is no longer necessary to hold these amounts in escrow accounts, they must be accounted for on a separate basis.

Amounts may be deferred for no longer than 18 months following the date on which benefits would otherwise be scheduled to commence. If a payment is deferred during this 18-month period, that payment, and each additional payment required to be made within the next 18 months, will be subject to segregation.

If the administrator determines the order is a QDRO within this 18-month period, payment of the segregated amounts will be made to the person(s) entitled to receive them. If the order is found to not to be a QDRO within this 18-month period and the plan administrator has received notice that either party involved in the dispute is attempting to rectify the order's deficiencies, payment of the participant's benefit may be delayed until such period expires.

k. Cash-Out Rules ($3,500)

The Act provides that only the vested portion of a participant's accrued benefit will be considered in determining whether its present value exceeds $3,500. Under pre-TRA law, both the vested and nonvested portions of a participant's accrued benefit were used to calculate its present value.[111]

If the present value a participant's vested accrued benefit exceeds $3,500, an immediate distribution of all or part of the benefit cannot be made without the consent of

[103] Act §1898(b)(10), amending REA §§103 and 203, Code §417(f), and ERISA §205.

[104] Act §1898(b)(12), amending REA §§103 and 203, Code §417(f)(2), and ERISA §205(h)(2).

[105] Act §1898(c)(4), amending REA §§104 and 204, Code §414(p), and ERISA §206(d)(3).

[106] Act §1898(c)(5), amending REA §§104 and 204 and ERISA §206(d)(3).

[107] Act §1898(c)(6), amending REA §§104 and 204, Code §414(p)(5)(A), and ERISA §206(d)(3)(F)(i).

[108] Act §1898(c)(7)(A)(v), amending REA §§104 and 204 and Code §414(p).

[109] Act §§1898(c)(7)(A)(v) and 1898(c)(7)(B)(ii), amending REA §§104 and 204, and Code §414(p)(4)(B), and ERISA §206(d)(3)(E)(ii).

[110] Act §1898(c)(2), amending REA §§104 and 204, Code §§414(p)(7)(A), (B) and (C), and ERISA §§206(d)(3)(H)(i), (ii), (iii) and (iv).

[111] Act §1898(d)(1), amending REA §§105 and 205, Code §411(a)(11)(A), and ERISA §203(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the participant and/or spouse. For purposes of this provision, an immediate distribution is deemed to occur if payment is made prior to the participant's normal retirement age or, if later, the date the participant attains age 62.

l. Transition Rules

The Act clarifies the scope of the transitional qualified pre-retirement survivor annuity rules in cases where participants had named non-spouse beneficiaries.[112]

Benefits payable to the designated beneficiary of a participant who performs at least one hour of service under the plan after August 23, 1984 and dies before both the annuity starting date and the effective date of REA will be subject to the qualified pre-retirement survivor benefit transitional rules. Under this amendment, the present value of any amounts payable to the participant's surviving spouse under these transitional rules will be used to reduce the present value of any death benefits payable to the beneficiary of such participant. If the participant designates more than one beneficiary, the present value of the death benefit payable to each beneficiary will be reduced proportionately.

Spouses may waive their rights to receive the qualified pre-retirement survivor annuity, with certain restrictions. If the waiver is made on or before the end of the second plan year after the provisions of REA apply, it is not treated as a transfer of property subject to the gift tax, prohibited assignment or alienation provisions of the Code or ERISA. In addition, death benefits waived by surviving spouses will not be included in their gross income, but in the gross income of the recipients.

The Act also provides that certain payments made under a profit sharing or stock bonus plan to a surviving spouse in a form other than a life annuity will be considered to satisfy the survivor benefit provisions of REA. Plans which were not technically exempt from the survivor benefit requirements during the transitional period or which did not satisfy the transitional rules with respect to a participant who died during that period, although amended in a timely manner to provide such exemption, will not be considered to violate the provisions of REA merely because they paid the participant's entire vested account balance to the surviving spouse in a form other than a life annuity.[113]

2. Tax Reform Act of 1984

a. Rollovers

The 1986 TRA permits the entire balance to the credit of an employee in a qualified plan to be eligible for rollover treatment under the partial distribution rules, provided the distribution is not a "qualified total distribution." Previously, only distributions representing a portion of the balance to the credit of an employee were deemed to be "partial distributions." [114]

Further, the Act clarifies that accumulated deductible employee contributions, as defined in Code §72(o)(5), will be disregarded in determining the balance to the credit of an employee under the revised partial distribution rules.[115]

Also, the Act clarifies that self-employed individuals will generally be treated as employees in determining the taxability of their distributions and the applicability of the rollover distribution rules.[116]

The Act provides that distributions received after an employee's death may be rolled over by the surviving spouse into IRAs only. Previously, the surviving spouse was permitted to roll the distribution over into any type of qualified plan, including individual retirement accounts.[117]

b. Distributions from Employee-Funded Plans

The Act clarifies that plans will be considered substantially employee-funded if 85% or more of the contributions made during a representative period are employee contributions. Further, all deductible employee contributions, as defined in Code §72(o)(5)(A), will be disregarded in determining the percentage of employee contributions.[118]

Further, the penalty imposed on premature distributions from annuity contracts will not apply to distributions which are made from a plan that is funded substantially through employee contributions.[119]

c. Estate Taxation

The Act repeals the exemption from estate and gift taxes for annuities created pursuant to community property laws. Under pre-1986 TRA law, contributions made to a revocable trust created under such laws were not included in the spouse's estate if he/she predeceased the employee.[120]

The Act modifies the grandfather rules under §525(b) of the Tax Reform Act of 1984 and §245(c) of the Tax Equity and Fiscal Responsibility Act of 1982 (concerning the repeal of the estate tax exclusion for qualified plan benefits) to provide that an election made under a qualified plan is irrevocable if all other conditions required for such grandfathering are met and the form of benefit distribution is not changed prior to death. Specific language has also been added to make the grandfather rules applicable to individuals who separated from service on or before January 1, 1985 (under the Tax Reform Act of 1984) or January 1, 1983 (under TEFRA) should the form of distribution elected not require payment until a subsequent date.[121]

---

[112] Act §1898(h)(1), amending REA §§303(c) and 2503.

[113] Act §1898(h)(3), amending REA §§303(c)(2).

[114] Act §1852(b)(1), amending §522 of the Tax Reform Act of 1984 and §402(a)(5)(E)(v).

[115] Act §1852 (b)(2), modifying §522 of the Tax Reform Act of 1984 and Code §402(a)(5)(D)(i).

[116] Act §1852(b)(3), amending §522 of the Tax Reform Act of 1984 and Code §402.

[117] Act §1852 (b)(4), amending §522 of the Tax Reform Act of 1984 and Code §402(a)(7).

[118] Act §1852(c)(1), modifying §523 of the Tax Reform Act of 1984 and Code §72(e)(7)(B).

[119] Act §852(c)(2), modifying §523 of the Tax Reform Act of 1984 and Code §72(q)(2)(E).

[120] Act §1852(e)(1), amending §525 of the Tax Reform Act of 1984 and repealing Code §2039(c).

[121] Act §1852(e)(3).

III. Penalty Tax on Early Distributions from Qualified Plans

A. *Introduction*

1. *Withdrawal Restrictions*

Typically, under pre-1986 TRA law, benefits under defined benefit plans could be distributed to participants only on account of plan termination or the employee's separation from service, disability, or death. Defined contribution plans, generally, could permit the withdrawal of employer contributions after the expiration of a stated period of time or after the occurrence of a stated event such as hardship. Under pre-TRA law, however, special restrictions applied to the withdrawal of benefits from qualified cash-or-deferred arrangements (CODAs). Under pre-TRA law, CODAs could not permit a participant to withdraw elective deferrals (or earnings on those deferrals) until the participant's death, disability, separation from service, attainment of age 59½ or hardship. Hardship was defined under proposed regulations as an immediate and heavy bona fide financial need for which the participant does not have other resources reasonably available to satisfy the need.

With regard to tax-sheltered annuity programs invested in a custodial account of a regulated investment company such as a mutual fund, pre-TRA law provided that distributions could not be made to participants until the participant attained age 59½, died, became disabled, separated from service, or encountered financial hardship.

In general, the 1986 TRA, revised these rules concerning withdrawal restrictions and imposed more stringent withdrawal restrictions on all types of tax-favored retirement arrangements (with the exception of deferred compensation arrangements under Code §457) because Congress desired to strengthen the incentives for taxpayers to save for retirement and not divert those savings to non-retirement uses. Congress was also concerned that the rules concerning the events upon which distributions may be made were not uniform for all types of retirement arrangements.[122]

2. *Additional Income Tax on Early Distributions*

Under pre-TRA law, a 10% additional income tax was imposed on withdrawals from an IRA if the withdrawal was made before the owner attained age 59½, died or became disabled. A similar 10% additional income tax was imposed on all withdrawals from qualified plans made by or on behalf of 5% owners who had not yet attained age 59½, died, or become disabled.[123]

To encourage retirement saving and discourage distributions before retirement age, Congress enacted a uniform 10% tax for all early distributions includable in gross income from all tax-favored retirement plans (with the exception of unfunded deferred compensation plans of tax-exempt or state and local government employers under post-TRA Code §457). Recognizing a different purpose for ESOPs (to create an ownership interest for employees in employer securities and not necessarily to provide a vehicle for retirement saving), however, Congress exempted early distributions from ESOPs from the additional tax.

B. *Overview*

The Act revised the withdrawal rules with respect to CODAs and imposed restrictions on withdrawals from tax-sheltered annuity plans. It also imposed a revised tax on certain "early" distributions.

1. *Withdrawal Restrictions with Regard to Elective Deferrals*

The 1986 TRA revised prior law concerning withdrawals from CODAs attributable to a participant's elective deferrals. The Act permits withdrawals on (1) the termination of a plan even if there is no successor plan; [124] (2) the sale by a corporation of substantially all of its assets where its employees continue employment with the successor corporation; [125] and (3) the sale of a subsidiary by a corporation where its employees continue employment with the subsidiary.[126] The provisions apply only where the distribution consists of the participant's entire interest in the CODA; [127] They are effective retroactively to distributions after December 31, 1984.[128]

With regard to tax-sheltered annuity plans, the Act imposes limits on withdrawals from elective contributions (and the earnings thereon).[129] Distributions attributable to such amounts may only be made after the annuitant reaches age 59½, dies, becomes disabled or separates from service.[130] Hardship withdrawals are permitted only for amounts attributable to the elective deferrals, without the earnings thereon.[131] This provision is effective for taxable years beginning after December 31, 1988.

2. *Additional Tax on Early Distributions*

The Act imposes an additional income tax of 10% on the amounts includable in income as a result of an early distribution.[132] The tax applies to distributions from qualified retirement plans (plans qualifying under Code §401(a), 403(a), 403(b) and IRAs) if made before the participant attains age 59½, dies, or becomes disabled.[133] There are exceptions, however, for distributions which are: (1) made in annuity form for the participant's life; (2) made to an employee after separation from service on account of a plan's provisions permitting early retirement at age 55; (3) dividend distributions under Code §404(k); (4) amounts used for medical expenses that do not to exceed the deduction allowed for such expenses; (5) distributions from ESOPs under certain circumstances; and (6) payments to alternative payees under qualified domestic relations orders.[134] (Exceptions (2), (5) and (6) do not apply

[122] House Report, p. 728; Senate Report, p. 612-13.
[123] Code §§72(m)(5) and 401(d)(5)(C).

[124] Act §1116(b). Code §401(k)(2)(B)(i)(II).
[125] Act §1116(b). Code §401(k)(2)(B)(i)(III).
[126] Act §1116(b). Code §401(k)(2)(B)(i)(IV).
[127] Conference Report, p. II-455.
[128] Act §1116(f)(6).
[129] Act §1123(c). Code §403(b)(11).
[130] Act §1123(c). Code §403(b)(11).
[131] Act §1123(c). Code §403(b)(11).
[132] Act §1123(a). Code §72(t)(1).
[133] Act §1123(a). Code §72(t)(2).
[134] Act §1123(a). Code §72(t)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

to IRAs).[135] In general, these provisions apply to taxable years beginning after December 31, 1986.[136] There are some exceptions.

C. *Detailed Analysis*

1. *Withdrawal Restrictions*

The Act imposes several restrictions on withdrawals from §401(k) CODAs and also permits certain distributions not previously permitted from cash or deferred arrangements.

The Act also imposes certain withdrawal restrictions on Code §403(b) annuity plans.[137] The Act specifically provides that distributions before age 59½ from §403(b) tax-sheltered annuities may only occur if the employee separates from service, dies, or becomes disabled, or demonstrates hardship. The distributions may only be attributable to contributions pursuant to a salary reduction agreement within the meaning of §402(g)(3)(C).[138]

Note: Code §403(b) annuity contracts may not provide for the distribution of any income attributable to such contributions in the case of hardship.[139]

Note that, with regard to tax-sheltered annuities that are invested in regulated investment company stock (mutual funds), the Act also amended the Code to clarify that withdrawals for financial hardship can only be made with respect to contributions pursuant to a salary reduction agreement.[140]

Under pre-TRA law, if a 5% owner (as defined in §416) received a distribution from a qualified plan or a §403(a) annuity §403(a) before the individual attained age 59½, for any reason other than becoming disabled, to the extent the amounts received were attributable to contributions paid on his behalf while he was a 5% owner, a 10% additional income tax was imposed. The Act provides that such amounts distributed to a 5% owner or a successor of such an individual, will be subject to the 10% tax only to the extent that the amounts distributed are determined, under regulations prescribed by the Secretary, to exceed the benefits provided for the individual under the plan formula.[141]

With regard to IRAs, the Act repeals Code §408(f) which imposed an additional tax on early distributions from IRAs because, after the TRA, the general rules on the additional tax on early withdrawals apply to IRAs.[142]

The amendments to §403(b) imposing withdrawal restrictions apply to taxable years beginning after December 31, 1988. The technical changes to §72(m)(5)(A) concerning distributions to 5% owners as well as the repeal of §408(f) concerning the additional tax on early distributions from IRAs are effective for taxable years beginning after December 31, 1986.

None of the changes apply to any benefits for which a designation is in effect under TEFRA §242(b)(2). There is also an exception for certain distributions which were part of a pay status participant's election to receive benefits pursuant to a specific schedule for the distribution of the entire amount of such participant's accrued benefit, where the distribution is made pursuant to a written election and the employee has separated from service as of March 1, 1986.[143]

2. *Additional Income Tax on Early Withdrawals*

a. *General Rule*

The Act imposes on distributions made before age 59½, death or disability, a penalty tax equal to 10% of the amount of the distribution that is includable in the participant's gross income.[144]

The tax applies to distributions from plans qualified under §401(a), annuity plans described in §403(a), tax-sheltered annuities under §403(b), and IRAs. The term does not include deferred compensation arrangements under plans sponsored by tax-exempt organizations or state and local governments under §457.[145] The extra tax, plus the 1986 TRA §72 basis recovery rules will create a substantial disincentive to making withdrawals from qualified plans before age 59½.

b. *Exceptions*

(1) *Periodic Payments*

The early distribution tax does not apply to distributions that are part of a series of substantially equal periodic payments made at least annually for the life or life expectancy of the employee or the joint lives (or joint life expectancies) of the employee and his beneficiary.[146]

If periodic payments are elected and therefore not taxed, and then, subsequently, the periodic payments are modified (other than by reason of death or disability) within five years of the first payment and after the employee attains age 59½, or simply before the employee attains age 59½, the tax will be recaptured.[147] The recapture tax applies to the first taxable year in which the modification occurs and must be increased by an amount, determined under regulations, equivalent to the tax that would have been imposed, plus interest for the deferral period.[148] The deferral period is defined as the period beginning with the taxable year in which the distributions should have been included in gross income and ending with the taxable year in which the modification which triggers the tax occurs.[149]

Example: If, at age 50, a participant begins receiving payments under a distribution method which provides for

---

[135] Act §1123(a). Code §72(t)(3).
[136] Act §1123(e)(1).
[137] Act §1123, adding Code §403(b)(11).
[138] Code §403(b)(11).
[139] *Id.*
[140] Act §1123(c)(2), amending Code §403(b)(7)(ii).
[141] Act §1123(d)(1), amending §72(m)(5)(A).
[142] Act §1123(d)(2), repealing Code §408(f). Amended Code §72(t)(1) requires that distributions from a "qualified retirement plan," if no exceptions apply, are to be taxed by an amount equal to 10% of the portion of the distributed amount which is includable in gross income. Qualified retirement plan is defined to include IRAs. (Act §1123(a) amending Code §72 by the addition of subsection (t). See amended §72(t)(1).).
[143] Act §1123(e).
[144] Act §1123(a). Code §72(t)(1).
[145] *Id.*
[146] Act §1123(a). Code §72(t)(2)(A)(iv).
[147] Act §1123(a). Code §72(t)(4).
[148] Act §1123(a). Code §72(t)(4)(A).
[149] Act §1123(a). Code §72(t)(4)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

substantially equal payments over the individual's life expectancy, and, at age 58, the individual elects to receive the remaining benefits in a lump sum, the additional tax applies to the lump sum and to amounts previously distributed.[150] Further, even if the method of distribution is modified after the individual attains age 59½, the recapture tax will apply if the individual does not receive payments under a method that qualifies for the exception for at least five years. Therefore, if an individual begins receiving payments in substantially equal installments at age 56, and alters the distribution method to a form that does not qualify for the exception before he attains age 61, the additional tax will be imposed on amounts distributed before age 59½ as if the exception had not applied. The additional tax, however, will not be imposed on amounts distributed after age 59½.[151]

The five-year minimum payout rule is waived on the death or disability of the employee.[152]

The exception for periodic payments made for life does not apply to distributions from qualified plans, Code §403(a) and §403(b) annuity contracts, or from IRAs unless the series of payments begin *after* the employee separates from service.[153]

(2) Early Retirement

The 10% tax does not apply where an employee separates from service on account of early retirement under the plan after attaining age 55.[154]

This exception applies to both normal and early retirement following the attainment of age 55, and continues to apply if the employee returns to work for the same employer or for a different employer.[155] As a result, for example, the exception applies to a distribution to an employee who, on or after age 55, retires under a plan which provides for a normal retirement age of 55. The exception would not apply, however, to a participant who separates from service at age 52 and, pursuant to the early retirement provisions of the plan, begins receiving benefits at or after age 55. (Other exceptions, however, may apply.)[156]

Note also that if, upon retirement under one plan of the employer, the employee is entitled to a lump sum distribution from another plan of the employer, the early retirement exception still applies. Thus, if an employer maintains a defined benefit plan that provides for early retirement on separation from service after age 55 and also maintains a profit sharing plan which permits the participant to obtain a lump sum distribution upon retirement under the defined benefit plan, the distributions from both plans qualify for the exception.[157]

Note: An existing plan which does not have an early retirement provision may be amended to add an early retirement provision which qualifies for this exception.[158]

Comment: It is unclear how the "early retirement" exception will apply, if at all, to self-employed individuals because the concept of "separation from service" has not previously been applied to the self-employed.

(3) Dividend Distributions from Certain ESOPs

The tax also does not apply where the distributions are dividends paid with respect to the stock of a corporation described in Code §404(k).[159]

(4) Distributions to Pay for Medical Expenses

The Act provides that an early distribution used to pay an employee's medical expenses (or medical expenses of a family member) will not be taxed to the extent that the distribution does not exceed the employee's medical expense deduction under Code §213.[160] That is, amounts distributed to pay medical expenses that exceed 7½% of adjusted gross income, qualify for the exception regardless of whether the taxpayer itemizes deductions.

(5) Distributions from ESOPs Meeting Certain Criteria

The tax does not apply to distributions from an ESOP meeting certain requirements.[161] Specifically, the Act exempts distributions from an ESOP but restricts the exception to distributions made before January 1, 1990 to the extent that, on average, a majority of plan assets have been invested in employer securities (within the meaning of §409(1)) at all times during the five-year period preceding the plan year in which the distribution is made.[162]

Where an ESOP has been in existence for less than five years, a majority of the plan assets has been invested in employer securities during the entire period before the distribution.[163] Where a plan is converted to an ESOP, plan assets must have been invested for five plan years prior to distribution in employer securities. The Conference Report indicates, however, that a distribution from an ESOP that satisfies the preceding conditions, will not qualify for the exception from the early distribution tax unless the distribution is attributable to assets that have been invested in employer securities for the five-year period. Tacking of investment periods is permitted.[164]

Note: The Conference Report indicates that amounts transferred to an ESOP following a reversion from a defined benefit plan would qualify for the exception if a majority of the amounts transferred is invested in employer securities upon the transfer and the five-year investment requirement is met. It is intended that a first-in, first-out rule be used for purposes of determining the length of time a plan has held securities distributed to a participant.[165]

(6) Payments to Alternate Payees

The tax does not apply to payments to an alternate payee pursuant to a qualified domestic relations order within the meaning of Code §414(p)(1).[166]

---

[150] Conference Report, p. II-457.
[151] *Id.*
[152] *Id.*
[153] Act §1123(a). Code §72(t)(3)(B).
[154] Act §1123(a). Code §72(t)(2)(v).
[155] Conference Report, p. II-456.
[156] Conference Report, p. II-456-57.
[157] Conference Report, p. II-457.
[158] *Id.*
[159] Act §1123(a). Code §72(t)(2)(vi).
[160] Act §1123(a). Code §72(t)(2)(B).
[161] Act §1123(a). Code §72(t)(2)(B) and (C).
[162] Act §1123(a). Code §72(t)(2)(C)(ii).
[163] Conference Report, p. II-457.
[164] Conference Report, p. II-458.
[165] *Id.*
[166] Act §1123(a). Code §72(t)(2)(D).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(7) Special Lump Sum Distributions on Account of Plan Terminations

There is also an exception for lump sum distributions made before March 16, 1987, if the distribution is on account of a separation from service in 1986 and the employee treats the distribution for federal tax purposes as paid in 1986.[167]

(8) Miscellaneous

The exceptions for medical expenses and for distributions from ESOPs, as well as the exception for distributions after separation from service on account of early retirement under the plan after attainment of age 55, do not apply to individual retirement plans.[168]

Comment: While the legislative history indicates that the additional income tax on early withdrawals should not apply to involuntary cash-outs of amounts of $3,500 or less,[169] Tax Management understands that Treasury apparently intends to disregard the Conference Report because it is not supported by the statutory language.[170]

The exceptions to the early distribution tax rules are available to 5% owners to the same extent that they are available to all other employees.

c. Other Early Distributions — Non-Qualified Plans

The 10% tax on early distributions also applies to annuity contracts that do not fund qualified plans or tax-sheltered annuities.[171] The 5% income tax under pre-TRA law for early distributions from non-qualified annuities was increased to 10%, and the exception for "substantially equal" payments was revised to reflect the same provision applicable to qualified plans.[172] Exceptions from the tax were added for distributions under an immediate annuity contract and where an employer-purchased annuity at qualified plan termination is held until the employee separates from service.[173]

d. Effective Dates

The provisions concerning the additional income tax on early withdrawals apply to all distributions made in taxable years beginning after December 31, 1986. There is an exception, however, for individuals who, as of March 1, 1986, separated from service and commenced receiving benefits pursuant to a written election designating a specific schedule of benefit payments.[174]

Note: If the participant failed to make a written election, the requirement that benefits be paid pursuant to a written election will be deemed satisfied if the plan from which the benefits are paid provides for only one form of distribution or where (1) the plan provides that, absent an election to the contrary, a participant will be paid benefits according to the automatic form of payment specified in the plan, and (2) the individual is, in fact, receiving benefits in that form.[175] Note also, that the tax does not apply to the special elections made pursuant to TEFRA §242(b)(2).[176]

D. Technical Corrections to Tax Reform Act of 1984

1. Penalty Tax

The 1986 TRA provides that the 10% penalty tax for distributions made prior to age 59½ which are not prompted by death or disability will be applied to those individuals meeting the post-TRA definition of 5% shareholder. This penalty will not apply, however, to amounts attributable to benefits accrued before January 1, 1985.[177]

The Act revises the definition of "5% owner." The revised definition of "5% owner" is restricted to those individuals who were 5% owners (as defined in §416(i)(1)(B)) at any time during the five plan years preceding the plan year in which their distributions are made, rather than to those individuals who were 5% owners at any time during their employment. Since an individual's status at the time of distribution is, after the TRA, the determining factor in judging whether the premature distribution penalty applies, it is no longer necessary to separately account for those amounts contributed while the individual was not a 5% owner.[178]

2. Minimum Distributions

The Act makes a series of modifications to the minimum distribution rules.

The Act provides that distributions from an Individual Retirement Account or Individual Retirement Annuity contract must begin no later than the April 1 of the calendar year following the year in which the owner reaches age 70½, regardless of whether such individual has retired. Previously, such distributions had been required as of the April 1 of the calendar year following the year in which the employee reached age 70½ or retired, whichever was later. This provision also clarifies that such distributions are subject to the incidental benefit rules of Code §401(a).[179]

The Act adds provisions indicating that incidental benefit distributions will be treated as meeting the rules applicable to required distributions.[180]

IV. Loans

A. Introduction

ERISA permits a plan participant to borrow from a qualified plan in which he or she participates provided the loan bears a reasonable rate of interest, is adequately secured, is available to all participants and beneficiaries on

[167] Act §1124(a).
[168] Act §1123(a). Code §72(t)(3)(A).
[169] Conference Report, p. II-456.
[170] *See* the enrolling resolutions passed by both Houses of Congress containing technical corrections to the Act, clarifies this point.
[171] Act §1123(b).
[172] Act §1123(b)(1) and (2). Code §72(q).
[173] Act §1123(b)(3). Code §72(q)(2).
[174] Act §1123(e)(3).
[175] Senate Report, p. 617.
[176] Act §1123(e)(4).
[177] Act §1852(a)(2)(A), amending §521 of the Tax Reform Act of 1984 and Code §72(m)(5)(A).
[178] Act §1852(a)(2)(B), amending §521 of the Tax Reform Act of 1984 and Code §72(m)(5)(C).
[179] Act §1852(a)(1)(A) and (B), modifying §521 of the Tax Reform Act of 1984 and Code §§408(a)(6) and 408(b)(3).
[180] Act §1852(a)(6), modifying §521 of the Tax Reform Act of 1984 and Code §401(a)(9).

a reasonably equivalent basis, is not made available to highly compensated participants in an amount greater than the amount made available to other participants, and is made in accordance with a specific plan provision regarding loans.[181] In general, the Code treats loans from qualified plans to participants as distributions, taxable to the participant as a distribution of plan benefits. There is an exception to this general rule for amounts withdrawn from a plan (by a participant) which do not exceed the lesser of: (1) $50,000 or (2) the greater of $10,000 or ½ of the participant's accrued benefit under the plan. The exception applies, in general, if the loan, by its terms, had to be repaid within five years.[182] Before the Tax Reform Act of 1986, the Code also provided that loans could be repaid within a reasonable period, not limited to five years, if the loan was used to acquire or improve a principal residence of the participant or a member of the participant's family.

Congress found two flaws with the rules governing the exceptions to the tax treatment of loans.[183] First, with regard to the $50,000 limit, Congress noted that some participants were borrowing from plans on an ongoing basis, effectively maintaining a permanent outstanding $50,000 loan balance through the use of balloon repayment obligations and bridge loans from third parties. Because maintaining a permanent outstanding loan balance did not carry out the congressional policy of encouraging retirement savings, Congress decided to limit the extent to which an employee could currently use assets held by a plan for non-retirement purposes and to insure that loans were actually repaid within a reasonable period.[184] In addition, with regard to the extension on the five-year repayment rule for participants' principal residences, Congress felt that the exception should be limited to the purchase of the participant's principal residence and should not be used for the benefit of family members.[185] Congress noted that the prior law was overly broad and difficult to apply.

B. *Overview*

The Act revises some of the rules with respect to loans from qualified plans in Code §72(p). First, it limits the $50,000 tax-free loan limit, in general, to $50,000 less the highest outstanding unpaid loan balance in the year before the new loan.[186]

Second, loans that exceed a five-year repayment period are limited to those used for the purchase of the principal residence of the participant.[187]

Third, it requires that loan repayments be amortized over a level period for the term of the loan and that loan payments be made no less frequently than quarterly.[188]

Last, the Act denies an interest deduction for loans that are made to key employees and also, where the loan is secured by amounts attributable to elective deferrals under cash or deferred arrangements (§401(k)) or tax-sheltered annuity arrangements (§403(b)).[189] Interest deductions are further limited by the Act's general rules concerning the deduction of consumer interest.[190]

In general, the loan provisions are effective for loans made, renewed, renegotiated, modified, or extended after December 31, 1986.[191]

C. *Detailed Analysis*

1. *Fifty-Thousand-Dollar Limitation*

The Act modifies the exception to the income exclusion rule where there were outstanding unpaid loan balances in the preceding year, by reducing the $50,000 limit.[192] Specifically, a loan, when added to the outstanding balance of all other unpaid loans from the plan, cannot exceed $50,000 reduced by the excess, if any, of the highest outstanding balance of loans from the plan during the one-year period ending on the day before the date the loan is made, over the outstanding balance of loans from the plan on the date the loan is made.

Example: A's vested benefits in a qualified plan equal to $200,000. On January 1, 1987, A borrows $30,000 from the plan. On October 31, 1987, A's outstanding balance has been reduced to $20,000. On November 1, 1987, A wishes to make another loan without triggering a taxable distribution. Under the new rule, A may borrow another $20,000. This is because X (New loan) + $20,000 (outstanding balance) may not exceed $50,000 minus $10,000 (the $30,000 highest outstanding balance for the year minus $20,000 outstanding balance on the day before the loan is made) or $40,000. Therefore, X = no more than $20,000.[193]

2. *Amortization of Loan in Level Payments*

The Act requires that all loan repayments be amortized in level payments over the term of the loan.[194] Thus, the practice of borrowing from a plan and not making repayment until retirement, plan termination or benefit payments commence will result in the amount of the loan being treated as a taxable distribution.

The legislative history indicates that level amortization of payments does not apply to a period when an employee is on a leave of absence without pay for up to one year.[195] On the other hand, the TRA provision does not preclude repayment or acceleration of the loan before the end of the commmitment period.[196] Further, a plan may require that a loan be repaid in full upon termination of employment, notwithstanding the amortization requirement.

---

[181] ERISA §408(b)(1); Code §4975(d).
[182] Code §72(p)(2).
[183] *Generally, see* H.R. Rep. 841, 99th Cong., 2d Sess. pp. II 463-65 (1986) ("Conference Report") and H.R. Rep. 426, 99th Cong., 1st Sess., pp. 734-736 (1985)("House Report").
[184] House Report p. 735.
[185] *Id.*
[186] Act §1134(a). Code §72(p)(2)(A).
[187] Act §1134(d). Code §72(p)(2)(B)(ii).
[188] Act §1134(b). Code §72(p)(2)(C).
[189] Act §1134(c). Code §72(p)(3).
[190] *See* Act §511(b). Code §163(h).
[191] Act §1134(e).
[192] Act §1134(a), amending Code §72(p)(2)(A).
[193] Conference Report, p. II-465. Note that the example in the Conference Report contains a typographical error, but the correct result is $20,000.
[194] Act §1134(b), amending Code §72(p)(2).
[195] Conference Report, p. II-465.
[196] Conference Report, p. II-465.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

3. Home Loan Exception

In general, prior law limited a participant's outstanding loan balance to $50,000 and extended the time within which a loan could be repaid from five years to a reasonable period, if the loan was for the purchase or rehabilitation of a principal residence of the participant or a member of the participant's family. Thus, for example, under prior law, a participant could borrow funds for an undefined reasonable time to help a family member, such as a child, purchase a condominium to use as a residence while in college.

The Act modifies this extended repayment period to apply only to the purchase of the principal residence of the participant.[197] As a result, plan loans to improve the existing principal residence of the participant or to purchase a second home are subject to the five-year repayment rule.

4. Deductibility of Interest

In general, the deductibility of interest on loans from a qualified plan or tax-sheltered annuity will be subject to the rules in the Act restricting the deduction of consumer interest.[198] Thus, in general, the interest on a loan from a plan to purchase a principal residence, will be deductible by a participant if the security interest for the loan is perfected under loan law on the taxpayer's principal residence and the loan is not for more than the participant's cost basis in the property.[199] Further, the interest on a loan from a plan to a participant to cover medical expenses or education expenses will be deductible if the medical expense qualifies for deduction within the meaning of Code §213(d)(1)(A) and (B) or the education expense for the participant or his immediate family is for study at an educational organization described in Code §170(b)(1). To be deductible, the debt for these two purposes must be secured by the taxpayer's principal residence, or second residence.[200]

There is an additional restriction placed on deductibility of interest where the participant is a key employee (as defined in Code §416(i) (relating to top-heavy plans) and where the loan is secured by amounts attributable to elective §401(k) or, §403(b) deferrals. No interest is deductible with regard to any loans made under either of these two conditions, even if otherwise deductible under the new consumer interest rules.[201]

Note: The Conference Report states that, for interest paid after December 31, 1986, no basis is allowed with respect to any interest paid on a loan from a qualified plan or tax-sheltered annuity.[202] Thus, the payment of interest will not increase a participant's basis in the plan.

5. Effective Date

The TRA loan provisions apply to loans made, renewed, negotiated, modified, or extended after December 31, 1986. The Act treats any renegotiation, extension, renewal, or revision after December 31, 1986, of an existing loan as a new loan on the date of such change.[203]

Thus, a participant would be able to avoid the Act's restrictive provisions of the Act by borrowing money before the end of 1986. The consumer interest rules concerning deductibility of interest, however, are effective, for interest payments made after December 31, 1986, regardless of the loan effective date rules, unless the deduction is grandfathered under the consumer interest rules.[204]

V. Penalty Tax on Excess Distributions

A. Introduction

Under pre-1986 TRA law, distributions from the various plans in which a participant participated, including IRAs, were taxed separately and were not subject to any overall limitations. Finding that there was no need to permit a participant to accumulate multiple maximum benefits from several employers, as well as individual savings in an IRA, Congress imposed an excise tax on certain excess aggregate retirement distributions.[205]

B. Overview

The Act imposes a 15% penalty tax on "excess distributions." The tax is imposed on the individual with respect to whom the excess distributions are made and the amount of the tax is reduced by the amount, if any, of the tax on early distributions under Code §72(t).

In determining an excess distribution, all distributions, with certain exceptions, with respect to any individual during any calendar year must be aggregated. Thus, annual distributions from all tax-qualified plans, tax-sheltered annuities, and IRAs, to the extent includable in gross income must be aggregated.

Where the aggregate amount of such distributions in any one year exceeds the greater of $112,500 adjusted for inflation or $150,000, a 15% additional income tax is imposed on the excess. Where distributions are taken in the form of lump sums distributions, up to $750,000 (also to be adjusted for inflation) is exempt from the excise tax.

There are special "grandfather" rules with respect to large amounts of accrued benefits accumulated as of August 1, 1986, which require a special election. Also, although retirement distributions with respect to an individual made after the death of the individual are excluded from the computation of the excess for purposes of the income tax, the Act imposes an additional 15% estate tax on individuals that die with excess accumulations.

In general, the excise tax applies to excess distributions made after December 31, 1986, while the estate tax applies to the estates of decedents dying after December 31, 1986. The excise tax and the additional estate tax, however, do not apply where distributions are made in 1987, but were made as a result of a termination of a qualified plan occurring in 1986.

---

[197] Act §1134(d), amending Code §72(p)(2)(B)(ii).

[198] Conference Report, p. II-465. For the provisions on consumer interest, *see* Act §511(b), adding Code §163(h) and Conference Report, pp. II-154-56.

[199] Conference Report, p. II-154.

[200] Conference Report, pp. II-155-56.

[201] Act §1134(c), amending Code §672(p).

[202] Conference Report, p. II-465.

[203] Act §1134(e).

[204] Act §511(b) and Conference Report, p. II-154.

[205] House Report, p. 740.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

C. *Detailed Analysis*

1. *Income Tax on Excess Distributions*

The Act imposes a penalty tax equal to 15% of the excess distributions received with respect to any individual during any calendar year.[206] The individuals with respect to whom the excess distributions are made are liable for the tax.[207] The Act provides, however, a rule coordinating the taxation of early distributions with the taxation of excess distributions. This rule provides that the tax on excess distributions is to be reduced by the amount, if any, of the tax imposed on early distributions to the extent the tax on early distributions is attributable to amounts considered excess distributions.[208] As a result, no distribution will be subject to both a 10% and 15% penalty tax.

A retirement distribution with respect to any individual is defined as the amount distributed during the taxable year under: (1) any qualified employer plan with respect to which such individual is, or was, the employee, and (2) any individual retirement plan.[209] "Qualified employer plans" include: (1) qualified pension, profit-sharing or stock bonus plans described in §401(a), (2) annuity plans described in Code §403(a), or (3) annuity contracts described in Code §403(b). It also includes any plan or contract which was determined by the Secretary to be such a plan or contract.[210]

The term "retirement distribution" is somewhat of a misnomer because the tax is not applied to distributions at retirement but to *any* distribution.

Note: Apparently, the distribution of property will be included as part of any retirement distribution at its fair market value. As a result, net unrealized appreciation in employer securities, even though not includable in gross income, is included for purposes of determining whether there is an excess retirement distribution.

In determining whether annual retirement distributions are excess distributions, the Act provides that the following retirement distributions may be excluded:

(1) distributions with respect to an individual made after the death of the individual;

(2) distributions with respect to an individual payable to an alternate payee, pursuant to a qualified domestic relations order (within the meaning of Code §414(p)) if includable in the income of the alternate payee;

(3) distributions with respect to an individual which are attributable to the employee's investment in the contract (as defined in Code §72(f)); [211] and

(4) distributions to the extent not included in gross income by reason of a rollover.[212]

Although excess retirement distributions with respect to an individual made after the individual's death are not subject to the 15% tax, they are subject to a special additional estate tax under 1986 TRA rules for post-death distributions (*see* discussion below).

The Act also provides that a distribution that qualifies as a distribution pursuant to a qualified domestic relations order must be treated as a retirement distribution to the person to whom paid for purposes of the imposition of the 15% tax. As a result, such amounts will be subject to the tax, if any, to the extent that the recipient under all qualified domestic relations orders, and any other retirement distributions, receives aggregate amounts that exceed the amount determined to be an excess amount.

Where retirement distributions with respect to any individual during any calendar year are received not just by the individual but by one or more other persons, all distributions made on account of that individual are aggregated for purposes of determining the amount of the excess retirement distribution.[213]

Note: It may be possible to avoid the penalty tax on benefits that exceed the limit, or to minimize the impact, if benefits are paid out in part as a lump sum (or lump sums) and in part as periodic distributions. If the retirement distributions with respect to an individual during any calendar year include a lump sum distribution to which an election to forward average under Code §402(e)(4)(B) applies, then, the limit is applied separately to the lump sum distribution and to the other retirement distributions.[214] Thus, if in one calendar year an individual received a lump sum distribution of $750,000 from a qualified plan, he could also receive up to $150,000 from an IRA or IRAs and not trigger the penalty tax. (*See* discussion below concerning the dollar amount of the limits.)

a. *General Limits*

Despite a lack of clarity in the statutory language, Tax Management understands that, for periodic payments, the excess distribution is the aggregate amount of the retirement distributions with respect to a particular individual during any calendar year to the extent that the amount exceeds the greater of $112,500 as adjusted for inflation,[215] or $150,000.[216] This should be clarified in technical corrections, regulations and in the "Blue Book" prepared by the staff of the Joint Committee on Taxation.

In general, with regard to lump sum distributions for which an income averaging election (pursuant to Code §402(e)(4)(B)) is made, the limit is five times the periodic limit (*i.e.*, $750,000).[217]

Note: Since elections under Code §402(e)(4)(B) may not be made with respect to distributions from IRAs, the

---

[206] Act §1133(a). Code §4981(a).
[207] Act §1133(a). Code §4981(b).
[208] Act §1133(a). Code §4981(b).
[209] Act §1133(a). Code §4981(e)(1).
[210] Act §1133(a). Code §4981(e)(2).
[211] The Conference Report provides that distributions attributable to after-tax employee contributions will not be taken into account in applying the tax. (Conference Report, p. II-477.)
[212] Act §1133(a). Code §4981(c)(2).
[213] Act §1133(a). Code §4981(c)(3).
[214] Act §1133(a). Code §4981(c)(4).
[215] The $112,500 amount is to be adjusted for inflation at the same time and in the same manner as the adjustment to the plan contribution limitations in Code §415(d).
[216] Act §1133(a). Code §4981(c)(1) and §4981(c)(5)(C).
[217] Act §1133(a). Code §4981(c)(4). The $750,000 is to be adjusted for inflation at some time in the future because it is tied to the dollar limits on periodic distributions which are subject to increases in the consumer price index. *See* Act §1133(a). Code 4981(c)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

$750,000 limit will not be available with respect to distributions from IRAs.

Note: The Conference Report specifically provides that accrued benefits may not be reduced retroactively to avoid the penalty tax.[218]

b. "Grandfather" Limits

There is a grandfathering rule for benefits accrued as of August 1, 1986. In general, the rule is advantageous only for amounts accrued as of August 1, 1986, if such amounts exceed $750,000.

To take advantage of this rule where a lump sum distribution is taken, the accrued benefit of the employee as of August 1, 1986, must exceed $562,500 and the employee must elect on the employee's return filed for a taxable year ending before January 1, 1989, to have the rule apply. If the rule applies, the full amount of the accrued benefits as of August 1, 1986, will be protected, however, amounts accrued after August 1, 1986, will be subject to the 15% penalty tax. In the case of a defined contribution plan, the accrued benefit on August 1, 1986, is the participant's account balance on that date. In the case of a defined benefit plan, the accrued benefit on August 1, 1986, is determined by assuming the participant separated from service on that date.[219]

Comment: The statute is silent concerning whether earnings attributable to amounts accrued as of August 1, 1986, will be grandfathered. Treasury is considering grandfathering such earnings. This issue may be addressed in regulations.

If the grandfather rule is elected with regard to periodic payments, rather than for a lump sum distribution, a pro-rata rule is applied to the amounts not grandfathered.[220] As a result, the $112,500 limit, adjusted for inflation (and not the $150,000 limit) is applied. The difference between $112,500, adjusted for inflation, and the portion of the distribution attributable to the grandfathered amount will be exempt.

Example: Assume: (1) an accrued benefit as of August 1, 1986, of $600,000, (2) an accrued benefit on the date of distribution of $800,000, (3) an actual distribution to the employee for the calendar year of $100,000, and (4) the participant elects grandfathering. The full non-grandfathered amount of the distribution will be exempt from the tax as follows: the portion of the $100,000 attributable to the grandfathered amount is $75,000 ($600,000 divided by $800,000 times 100% equals $75,000). The difference between the limit ($112,500) and the grandfathered portion of the distribution ($75,000) is $37,500. Since this exempt amount exceeds the $25,000 of the distribution which is not grandfathered, the full $25,000 is exempt from tax. Given the same facts, however, but with a $200,000 distribution, the entire non-grandfathered portion of the distribution, $50,000, is subject to the tax.

[218] Conference Report, p. II-477.
[219] Conference Report, p. II-477.
[220] Act §1133(a). Code §4981(c)(5)(A).

Note: The Conference Committee authorized the Secretary of the Treasury to develop an alternate grandfather rule.[221]

2. Additional Estate Tax on Excess Distributions

While a retirement distribution with respect to an individual made after the death of the individual is excluded from consideration for purposes of the income tax on excess distributions,[222] the Act imposes an additional estate tax equal to 15% of the "excess retirement accumulation."[223] The most striking aspect of this provision is that it imposes an estate tax even if no other estate tax is imposed on the participant's estate.

The Act provides that the lifetime unified credit (equivalent to a maximum of $600,000 in exclusions) may not be applied with respect to excess retirement accumulations.[224] Moreover, because this tax is imposed without regard to the participant's taxable estate, neither the marital deduction nor the charitable deduction is available. Thus, an additional tax of 15% will be applied to excess retirement accumulations even if the participant's estate is otherwise shielded from federal estate tax because of the marital or charitable deductions, or the unified credit.

An "excess retirement accumulation" for estate tax purposes is defined as the value of the individual's interests in all qualified plans, tax-sheltered annuities and individual retirement plans, as of the date of the decedent's death,[225] minus the present value (as of the valuation date) of an annuity for a term certain with annual payments equal to $150,000 where the payments are payable for a period equal to the life expectancy of the individual immediately before his or her death.[226]

The Act does not specify how the value of the individual's interest in the specified plans or the present value of an annuity for a term certain is to be determined. It provides the Secretary with the discretion to establish rules for determining the present value of an annuity for a term certain as of the valuation date for determining the value of the individual's interest in the specified plans.[227] Presumably, because no discretion is delegated to the Secretary with regard to the valuation of the individual's interests in the plans, Congress may have intended that the estate tax valuation rules under Code §2039 and the tables in conjunction with Code §2031 should be used. Nevertheless, the Conference Agreement directs, in general, that reasonable rates of interest are to be used and that the Secretary may prescribe a range of interest rates and other permissible assumptions for determining the excess.[228]

Comment: While there is no direct statutory authority for applying the "grandfather" rules to distributions on

[221] Conference Report, p. II-478.
[222] Act §1133(a). Code §4981(c)(2).
[223] Act §1133(d). Code §4981(d)(1).
[224] Act §1133(a). Code §4981(d)(2).
[225] In computing the value of the individual's interest in the specified plans, the value of the interest on the alternate valuation date under Code §2032 may be substituted for the value as of the date of the decedent's death. Thus, the value as of six months after the date of death may be used. (Act §1133(a). Code §4981(d)(3)(A).)
[226] Act §1133(d). Code §4981(d)(3).
[227] Act §1133(a). Code §4981(d)(3)(B).
[228] Conference Report, p. II-477.

account of death, the author understands that their application was intended and that this will be clarified in future pronouncements. Although not entirely clear from the statutory language, the author further understands that the exceptions for purposes of the additional income tax also apply to the additional estate tax.[229] (Of course, however, the income tax exception for distributions at death is not an exception for purposes of the additional estate tax.) As a result, for example, amounts attributable to employee contributions and amounts rolled over to IRAs will not be included for purposes of calculating the excess retirement accumulation.

The application of the additional estate tax to distributions from qualified plans may make certain plan investments less desirable. For example, life insurance net death benefits which are paid from a qualified plan and which constitute excess distributions will be subject to the 15% additional tax that would not be applicable if the payments were made pursuant to a life insurance policy not owned by a qualified plan. Thus the tax will generate, for life insurance purchased through qualified retirement plans, a federal tax disadvantage that would not be present for other life insurance purchases.

The additional estate tax raises several issues that do not appear to have been contemplated by the drafters of the provision, and that, hopefully, will be addressed in future pronouncements. For example, the issue of how much will be subject to the tax in states where the spouse may be considered the owner of one-half of the accrued benefit is significant. It also is not clear whether the "income in respect of a decedent" (IRD) income tax deduction of Code §691(c) applies. If the individual dies with excess retirement accumulation, the tax imposed is considered an estate tax, since Code §4981(d)(1) states that the "tax imposed by Chapter 11 (the estate tax provisions) with respect to the estate of any individual shall be increased by an amount equal to 15% of the individual's excess retirement accumulation." [230] Because it is considered an estate tax, there should be an income tax deduction available under Code §691(c) for the amount of estate tax paid with respect to such property. Code §691(c)(2), however, states that the "term 'estate tax' means the tax imposed on the estate of the decedent . . . under Code §2001 . . ." It is not clear whether the TRA-enacted estate tax provision of Code §4981(d) creates a tax imposed under Code §2001.

3. Effective Dates

In general, the amendments concerning the penalty tax on excess distributions apply to distributions made after December 31, 1986. Note, however, that the Conference Report indicates that distributions made after August 1, 1986, but before January 1, 1987, will reduce the grandfathered amount.[231]

The additional estate tax applies to the estates of decedents dying after December 31, 1986.[232]

There is a special rule for distributions made in 1987 on account of a plan termination which occurred before January 1, 1987.[233] The penalty tax will not apply to such distributions.

D. Technical Corrections

1. Retirement Equity Act

a. Qualified Domestic Relations Orders

The Act provides that distributions made to a spouse or former spouse under a qualified domestic relations order (QDRO) are generally included in the gross income of the spouse rather than the participant.[234]

Distributions made under a QDRO to an alternate payee other than a spouse or former spouse are to be included in the gross income of the participant. In determining whether a distribution is eligible for lump sum distribution treatment, amounts paid to an alternate payee other than a spouse or former spouse are considered part of the balance to the credit of the participant.

In addition, the participant's investment in the contract is allocated between the participant and the payee only if the payee is a spouse or former spouse. If the alternate payee is not a spouse or former spouse, the investment in the contract is not allocated and may be recovered by the participant under the applicable basis recovery rules.

2. Tax Act of 1984

a. Rollovers by Surviving Spouses

The 1986 TRA provides that distributions received after an employee's death may be rolled over by the surviving spouse into IRAs only. Previously, the surviving spouse was permitted to roll the distribution over into any type of qualified plan, including individual retirement accounts.[235]

VI. Excise Tax on Reversion of Qualified Plan Assets to Employer

A. Introduction

Under pre-1986 TRA law, provided certain requirements were satisfied, employers were permitted to terminate qualified plans, primarily defined benefit plans, and obtain a reversion of any surpluses remaining after the payment of all promised benefits. To discourage such terminations, Congress imposed a 10% excise tax penalty on reversions of excess assets to employers.

Code §401(a) requires that qualified plans be maintained for the exclusive benefit of employees and their beneficiaries and that, unless all liabilities with respect to participants and their beneficiaries have been satisfied, assets of the plan may not be used for, or diverted to, other purposes.[236] There are certain exceptions, however, to this general rule. First, if assets remain in a defined benefit plan

[229] The author understands that Treasury officials interpret the reference to the limit of §4981(c) in Code §4981(d)(3)(B)(i) to include both the dollar limit in §4981(c)(1) and the exceptions to the tax in §4981(c)(2). This should be clarified in the "Blue Book" and in regulations.

[230] Act §4981(a). Code §4981(d)(1).

[231] Conference Report, p. II-477.

[232] Act §1133(c)(1)(2).

[233] Act §1133(c)(3).

[234] Act §1898(c)(1), amending REA §§104 and 204, Code §§402(a)(9) and 72(m)(10).

[235] Act §1852(b)(4), amending §522 of the Tax Reform Act of 1984 and Code §402(a)(7).

[236] Code §401(a)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

at plan termination as a result of actuarial error, then, after the plan has satisfied all liabilities, those assets may be returned to the employer. The Treasury, the Department of Labor and the PBGC jointly issued Implementation Guidelines which set forth the rules for certain terminations of qualified defined benefit plans involving reversions of excess assets. ERISA permits certain contributions to be returned to employers in three situations: (1) where the contribution is made by mistake of fact; (2) where the contribution is conditioned on initial plan qualification and the plan does not qualify; or (3) when the contribution is conditioned on its deductibility and the deduction is disallowed.

In general, all assets of a defined contribution plan must be distributed to employees. However, certain amounts properly allocated to a suspense account under a defined contribution plan may revert to the employer upon plan termination if the plan contains a provision permitting such reversion.[237]

In establishing an excise tax, Congress noted that, where plans are not used for retirement purposes and plan assets revert to the employer, the tax benefits should be recaptured. Noting that determining the particular year or years in which contributions resulting in a reversion arose and recouping the resulting tax benefit attributable to the reversion would involve undue complexity, Congress imposed a nondeductible excise tax at a uniform rate on reversions.[238] Congress did, however, provide an exception for transfers of excess assets from defined benefit plans to ESOPs to encourage employee stock ownership.[239]

B. Overview

To discourage asset reversions and to recapture the benefit of deferred earnings on contributions to qualified plans, Congress imposed a nondeductible 10% excise tax on all reversions of excess plan assets to employers with only one exception. The exception is for situations in which the amount of the reversion upon plan termination is transferred to an employee stock ownership plan. In general, the 1986 TRA provisions are effective for reversions occurring after December 31, 1985, except that the excise tax does not apply to reversions after that date which occur pursuant to a plan termination, where the termination date is before January 1, 1986. There are several exceptions to the effective date rules for particular employers that were able to obtain specific exemptions.

C. Detailed Analysis

1. In General

The 1986 TRA added Code §4980, imposing a 10% excise tax on reversions of qualified plan assets.[240] The tax is imposed on the person receiving the reversion, typically, the employer.

Note: For this purpose, in the case of a partnership that is treated as the employer maintaining the plan under Code §401(a), the partners are liable for the tax.[241]

The definition of a qualified plan, a reversion from which is subject to the excise tax, is any plan meeting the requirements of Code §401(a) or §403(a) or any plan which, at any time, has been determined by the Service to qualify as such a plan. Excluded from the definition of qualified plan are plans maintained by tax-exempt employers and governmental plans within the meaning of Code §414(d).[242] With respect to tax-exempt employers, the exception does not apply to the extent that the employer has been subject to unrelated business income tax or has otherwise derived a tax benefit from the qualified plan.[243]

The amount of the reversion subject to the excise tax is the amount of cash and the fair market value of other property received (either directly or indirectly) by an employer from the qualified plan.[244]

Except as provided in regulations, the Act provides an exclusion for any amounts distributed to or on behalf of any employee (or his beneficiaries) if the amount could have been distributed before termination without violating any of the provisions of Code §401.[245] Another exclusion from the tax is provided for a distribution to the employer that is allowed under Code §401(a)(2) where: (1) in the case of a multiemployer plan, the amount is returned to the employer as a result of a mistake of law or fact, or is a return of a withdrawal liability payment, (2) in the case of a non-multiemployer plan, the amount is returned as a result of a mistake of fact, and (3) in the case of any plan, the amount is returned due to the failure of the plan to initially qualify or the failure of contributions to be deductible.[246]

Note: A payment to an employer under a participating annuity purchased upon plan termination is treated as a reversion subject to the tax.[247]

2. Exception for ESOPs

An exception to the tax is provided for reversions on plan termination that are transferred to an ESOP.[248]

Note: The Conference Report provides that no inference should be drawn from this exception as to the circumstances in which asset transfers will or will not satisfy the exclusive benefit rule and any other applicable qualification requirements, for example, those under Code §414(l).[249]

The exception applies where the excess amount is transferred to an ESOP described in Code §4975(e)(7). The amount transferred must be invested in employer securities (as defined in Code §409(l)) or used to repay loans used to purchase such securities within 90 days after the transfer. Apparently, to avoid undue market disruption, the IRS is authorized to extend the 90-day period by regulation.[250] The plan must require that the amounts so transferred will remain in the plan until distribution to participants in accordance with the provisions of the plan.[251]

---

[237] Regs. §1.415-6(b)(6).
[238] Senate Report, p. 636.
[239] Senate Report, p. 636.
[240] Act §1132(a). Code §4980.
[241] Conference Report, p. II-483.
[242] Act §1132(a). Code §4980(c)(1).
[243] Conference Report, p. II-483.
[244] Act §1132(a). Code §4980(c)(2).
[245] Act §1132(a). Code §4980(c)(2).
[246] Act §1132(a). Code §4980(c)(2)(B).
[247] Conference Report, p. II-483.
[248] Act §1132(a). Code §4980(c)(3).
[249] Conference Report, p. II-483.
[250] Act §1132(a). Code §4980(c)(3)(A) and (B).
[251] Act §1132(a). Code §4980(c)(3)(A)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Further, at least half of the participants in the terminated qualified plan from which the reversion assets emanated must be participants in the transferee ESOP as of the close of the first plan year for which an allocation of the securities is required.[252] The 50% calculation must be made as of the date the notice of intent to terminate is filed with the PBGC.[253] For purposes of determining which participants are required to be participants in the ESOP, only active employees (as opposed to retirees) need be included.[254]

Note: An ESOP may be maintained by any member of a controlled group of corporations, including a corporation other than the corporation that maintained the terminated defined benefit plan as long as the 50% test is met with respect to the employees participating in the ESOP.[255]

A last requirement involves special allocation rules. The Act requires that any portion of the reversion amount that is transferred to the ESOP which is not allocated under the plan to the accounts of the participants in the plan year in which the transfer occurs must be credited to a suspense account and allocated from the suspense account to the accounts of participants no less rapidly than ratably over a period of up to seven years and, when allocated to the accounts of participants, must be treated as an employer contribution for purposes of Code §415(c), except that the value of the employer securities attributable to each such allocation must not be more than the value of the securities at the time they were credited to the suspense account and no additional employer contributions may be made to the ESOP before the allocation of the transferred reversion to the accounts of participants.[256] This prohibition against employer contributions, which includes elective deferrals, is not intended to prohibit contributions to an ESOP to the extent that the amount of the suspense account required to be allocated for a year, when combined with additional contributions, does not exceed the limits under Code §415.[257]

Apparently, if an ESOP is terminated before the amounts have been fully allocated to the participants' accounts, the employer will be subject to the 10% excise tax on the reversion amounts that have not yet been allocated.[258] Dividends paid on employer securities that are held in the suspense account must either be (a) applied to repay an acquisition loan, or (b) paid out currently to plan participants and beneficiaries in proportion to their account balances on the date that the dividends are distributed.[259]

Note: All employees participating in the ESOP as of the close of the plan year in which the employer receives a notice of sufficiency from the PBGC with respect to the terminated defined benefit plan must be entitled to share in that year's allocation of the excess assets in the ESOP.[260]

Note: Although not statutorily prescribed, the legislative history indicates that employers must provide employees with a written notice describing the source of funds attributable to the allocations. That is, the employees must be advised that the amounts represent excess assets determined upon termination of a defined benefit plan.[261]

3. Effective Date

This excise tax applies to reversions occurring after December 31, 1985, but does not apply to a reversion received after December 31, 1985, if the termination date of the plan is before January 1, 1986.[262] For these purposes, the termination date is considered to occur on the proposed date of termination within the meaning of Code §411(d)(3).[263] The Act also provides special effective date rules for particular unnamed employers.[264]

With regard to transfers to ESOPs, the special provision applies to amounts transferred after March 31, 1985, and before January 1, 1989, *or* amounts transferred after December 31, 1988, pursuant to a termination which occurs after March 31, 1985, and before January 1, 1989.[265]

VII. Deferred Annuities Available Only to Natural Persons

A. Introduction

A deferred annuity is an annuity contract under which payments begin only after a specified period elapses after the purchase of the contract. In general, a deferred annuity has both an accumulation phase when the annuity is funded and a payout phase when the benefits are distributed. By contrast, an immediate annuity only has a payout phase. Typically, deferred annuities are purchased in order to save for retirement. They are purchased by individuals and also, in many circumstances, by employers in order to fund the employer's obligation to provide nonqualified deferred compensation to its employees. Deferred annuities are also used to fund benefits provided under qualified pension plan, profit sharing or stock bonus plans.[266]

Under pre-1986 TRA law, income credited to a deferred annuity contract was not taxed currently to the owner of the contract or to the insurance company issuing the contract. Amounts received by the owner of the annuity contract before the annuity starting date (including loans under, or secured by, the contract) were taxed as ordinary income to the extent that the cash value of the contract exceeded the owner's investment in the contract. A portion of each distribution received after the annuity starting date was taxed as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

With the 1986 TRA, Congress determined that non-natural persons, such as corporations, that own annuity contracts should not continue to receive the favorable tax

[252] Act §1132(a). Code §4980(c)(3) and §4980(c)(3)(D).
[253] Senate Report, p. 637-638.
[254] Conference Report, p. II-483.
[255] Senate Report, p. 638.
[256] Act §1132(a). Code §4980(c)(3)(C).
[257] Conference Report, p. II-483.
[258] Senate Report, p. 637.
[259] Senate Report, p. 637.
[260] Senate Report, pp. 637-638.
[261] Senate Report, p. 638.
[262] Act §1132(c)(1) and (c)(2)(A).
[263] Act §1132(c)(3).
[264] Act §1132(c)(2)(B) and (c)(4).
[265] Act §1132(a). Code §4980(c)(3)(E).
[266] Senate Report, p. 567 and House Report, p. 703.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

treatment provided under pre-TRA law. Congress believed that the prior law rules relating to deferred annuity contracts permitted employers to fund, on a tax-free basis, significant amounts of nonqualified deferred compensation for employees, thereby creating a disincentive for employers to provide benefits under qualified plans which are subject to greater regulation.[267] In addition, because typically, annuity contracts are used to provide benefits to top executives rather than to employees generally (as is required in the case of qualified retirement plans), Congress was concerned that the prior law treatment of deferred annuity contracts diluted the effect of the nondiscrimination rules applicable to qualified plans.[268]

B. Overview

Under the 1986 TRA provision, any contract held by a person who is not a natural person (such as a corporation), is not treated as an annuity contract for federal income purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year. There are several exceptions to this general rule, including exceptions for qualified funding assets and annuities purchased by an employer on termination of a qualified plan. The provision has a retroactive effective date. It applies to contributions to annuity contracts after February 28, 1986.

The effect of this provision is to impose federal income taxation on the inside buildup of annuity contracts on employers who purchase annuity contracts to fund nonqualified deferred compensation arrangements. This provision will have a significant impact on the way that employers fund deferred compensation arrangements since many of these arrangements utilize annuity contracts as funding mechanisms.

C. Detailed Analysis

The Act adds Code §72(u).[269] The subsection provides that, if any annuity contract is held by a non-natural person, the contract: (1) is not treated as annuity contract for purposes of federal income taxation, and (2) the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the owner during that taxable year.[270] The statute indicates that the holding by a trust or other entity as an agent for a natural person will not be taken into account.[271] Thus, if a group annuity contract is held by a corporation as agent for natural persons who are the beneficial owners of the contracts, the contract is treated as an annuity contract for federal income tax purposes. If an employer is the nominal owner of an annuity contract, however, the beneficial owners of which are employees, the contract will nevertheless be treated as held by the employer.[272] The legislative history indicates that this rule was imposed because Congress was concerned that the Service would have difficulty monitoring compliance with the general rule that a deferred annuity is not available on a tax-favored basis to fund nonqualified deferred compensation.[273]

The term "income on the contract" is defined for these purposes, with respect to any taxable year of the policyholder, as the excess of: (1) the net surrender value of the contract as of the close of the taxable year, plus all distributions under the contract received during the taxable year or any prior taxable year, less (2) the amount of net premiums under the contract for the taxable year and prior taxable years, and amounts includable in gross income for prior taxable years with respect to the contract.[274] Net premiums are defined as the amount of premiums paid into the contract, reduced by any policyholder dividends.[275] Thus, income on the contract means the excess of: (1) the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed on the contract for all years, less (2) the investment in the contract, that is, the aggregate amount of the premiums paid under the contract, minus policy dividends or the aggregate amounts received under the contract that have not been included in income.

The statute authorizes the Secretary of the Treasury to substitute "fair market value of the contract" for "net surrender value of the contract" in appropriate cases if it is necessary to prevent avoidance of the otherwise required income inclusion.[276]

There are five exceptions to which these rules do not apply. There are exceptions for situations in which the annuity is acquired by the estate of a decedent by reason of the death of the decedent, and in which the annuity is held under a qualified plan (as described in Code §401(a) or §403(a)), a tax-sheltered annuity program (described in Code §403(b)) or under an individual retirement plan.[277] There is also an exception for a qualified funding asset (as defined in Code §130(d)), but without regard to whether there is a qualified assignment.[278] This exception covers: (1) qualified funding assets purchased by structured settlement companies, and (2) annuity contracts (which otherwise meet the definition of a qualified funding asset) purchased and held directly by a property or casualty insurance company to fund periodic payments for damages.[279] There is also an exception for an annuity contact purchased by an employer upon the termination of a plan (described in Code §401(a) or 403(a)) and which is held by the employer until such time as the employee separates from service.[280] The last exception is for an immediate annuity, which is defined as an annuity which is purchased with a single premium or annuity consideration where the annuity starting date commences no later than one year from the date of purchase of the annuity.[281]

Section 72(u) is effective for contributions to annuity contracts after February 28, 1986.[282]

---

[267] Senate Report, p. 567 and House Report, p. 703.
[268] Senate Report, p. 567 and House Report, p. 703.
[269] Act §1135.
[270] Act §1135(a). Code §72(u)(1).
[271] Act §1135(a). Code §72(u)(1).
[272] Senate Report, p. 567 and House Report, p. 704.
[273] Senate Report, p. 568 and House Report, p. 704.
[274] Act §1135. Code §72(u)(2).
[275] Act §1135. Code §72(u)(2)(B).
[276] Act §1135. Code §72(u)(2)(A) and Senate Report, p. 568 and House Report, p. 704.
[277] Act §1135(a). Code §72(u)(3)(A) and (B).
[278] Act §1135(a). Code §72(u)(3)(C).
[279] Conference Report, p. II-402.
[280] Act §1135. Code §72(u)(3)(D).
[281] Act §1135(a). Code §72(u)(3)(E) and §72(u)(4).
[282] Act §1135(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 58

AMENDMENTS TO EMPLOYMENT TAX RULES

Andrew Huddleston, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. Employment Taxes—General Rules

1. Federal Insurance Contributions Act (FICA)

If a worker is classed as an employee, his compensation, subject to a base limit, is subject to FICA taxes, commonly known as Social Security taxes, which the employer is required to withhold from the employee's pay.[1] If the employer fails to withhold the tax when he or she should, the employer is still liable for payment of the tax.[2] The employer is also required to match the withheld amounts.[3] The term "employer" includes any individual, corporation, partnership, or United States government instrumentality, as well as most trusts.[4] An employee is defined in §3121(d) by several categories, including the broadest and most controversial, common-law employee.[5] An employee's contract of service must contemplate that he will perform substantially all the services personally.[6] Moreover, the statute excepts those persons who have a substantial investment in facilities — other than transportation facilities — used in performing the services.[7] Also, the services must be a continuing relationship rather than a single transaction.[8]

2. Federal Unemployment Tax Act (FUTA)

Subject to a credit for certain payments made into a state unemployment fund,[9] an employer is required to pay a 6.2% tax on the first $7,000 of wages paid per employee in 1985 and thereafter.[10] No such payments are required for independent contractors, since wages are defined as all "remuneration for employment." [11] With particular exceptions, "employment" is defined as "any service, of whatever nature, performed . . . by an employee for the person employing him" [12] In turn, an employer is any person who paid wages of $1500 or more in any quarter of the current calendar year or the prior calendar year, or who employed at least one person for part or all of twenty different days, each day being in a different calendar week of the current calendar year or the prior calendar year.[13]

With two exceptions — full-time life insurance salespeople and certain types of household workers — whoever is an employee for FICA purposes is also an employee for FUTA purposes.[14]

3. Withholding Taxes

Whether an employer pays the employee in cash or otherwise, the employer must withhold income taxes from the wages paid an employee.[15] The statute omits, however, any definition of employment. An employee is defined for this chapter without reference to the FICA provisions.[16] An employer is a person for whom services are provided, unless that person lacks control over paying wages, in which case the one in control of payment is deemed to be the employer.[17] The employer is liable for the payment of withholding taxes whether or not the taxes are actually withheld.[18]

4. Self-Employment Contributions Act (SECA)

The self-employed person, or independent contract, pays his own Social Security taxes in the form of self-employment taxes.[19] Subject to the same base compensation limit applicable to employees, self-employment income is defined as "net earnings from self-employment" less wages subject to withholding. If, however, the net earnings from self-employment are less than $400, no tax is due.[20]

5. Classifying Workers

Most workers classed as employees are common law employees, that is, persons who perform services for others within the legal relation of employer to worker under the usual common law rules.[21]

The regulations set forth the relevant factors in deciding doubtful cases under the usual common law rules. Generally the relationship exists when the person for whom

---

[1] Code §3102(a).
[2] *See* Code §3102(b).
[3] Code §3111.
[4] Code §3121(h).
[5] *See* Code §3121(d)(2).
[6] Code §3121(d).
[7] *Ibid.*
[8] *Ibid.*
[9] Code §3302.
[10] Code §§3301, 3306(b)(1).
[11] Code §3306(b).
[12] Code §3306(c).
[13] Code §3306(a)(1).
[14] Code §3306(i).
[15] Code §§3401(a) and 3402(a)(1).
[16] *See* Code §3401(c).
[17] Code §3401(d).
[18] Code §3403
[19] Code §1401.
[20] Code §1402(b).
[21] *See* Employment Tax Regs. §31.3121(d)-1(c)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

services are performed has the right to control and direct the person who performs the services, not only for the result of the work but also on the details and means to accomplish that result. It is not necessary that the employer actually direct or control the manner of performing the services; the right to do so is sufficient. The right to discharge a worker is also an important factor in identifying an employer. Another frequent but not invariable characteristic is the furnishing of tools or a place to work. A person who is subject to control only on the result to be accomplished is generally an independent contractor. Workers such as doctors, lawyers, dentists, veterinarians, construction contractors and public stenographers, who pursue an independent trade in which they offer services to the public, are independent contractors, rather than employees.[22]

B. Treatment of Certain Technical Personnel

Section 530 of the Revenue Act of 1978 [23] contains an exception to the general rules for employment taxes that allows taxpayers who have had a reasonable basis (such as industry practice) for treating certain workers as independent contractors rather than employees to continue this practice, thereby avoiding liability for employment taxes under FICA.

C. Exemption for Certain Clergy

Another exception to the general rule for employment taxes is made for ministers of a church, members of religious orders and Christian Science practitioners (referred to in the Code as "ministers"), who are treated as being self-employed for purposes of SECA, even though they may actually receive salary or wages which would ordinarily be taxed under FICA.[24] Further, under §1402(e)(2), if a minister has conscientious or religious objections to participation in an insurance plan such as Social Security, he may make an election to be exempt both from the self-employment tax and from receipt of all benefits under Social Security. The election must be made with the I.R.S. within two years of the taxpayer's becoming a minister and is irrevocable under current law.[25]

D. Exception for Churches and Church Organizations

The Tax Reform Act of 1984 [26] added Code §3121(w) to allow to churches and certain church-controlled organizations an irrevocable election to exclude all services performed for them from the definition of employment under FICA. Thus, by this election, a church or church organization would be exempted from payment of any FICA taxes. Employees of a church which makes this election would be treated thereafter as being self-employed and liable for self-employment taxes under SECA on their payment for services to the church. In general, the amount of payment which would be subject to the self-employment tax would be the same as that which would have been subject to the FICA taxes.

Section 1402(g) of the Code allows an exemption from SECA taxes to self-employed members of religious sects whose tenets forbid participation in a government-sponsored medical, retirement or death insurance program. To obtain the exemption, an individual must file an application with the I.R.S., including evidence of the beliefs of the sect as well as of the member's adherence to them. The taxpayer must also waive all benefits under social security.

E. Application of the FUTA Tax to Indian Tribal Governments

Under pre-1986 TRA law, Indian tribal governments are treated identically to any other employer for payment of the federal unemployment tax (FUTA). There is no exception to coverage for Indian governments which have been denied unemployment compensation coverage by the state where the tribal government is an employer. *See* Conference Report at II-833.

II. Overview

Section 1706 of the Act modifies section 530 of the Revenue Act of 1978 to disallow the treatment of certain technical personal as independent contractors by their employers for purposes of FICA taxes.

Section 1704(a) of the Act modifies Code §1402(e) to ensure that any person who chooses exemption from self-employment taxes will inform the religious body to which he belongs of the nature of his objection justifying the exemption. It further provides that the Secretary of the Treasury (or, by agreement, the Secretary of Health and Human Services) will verify that any person seeking this exemption understands the grounds on which it is available and that he seeks it on these grounds.

Section 1704(b) of the Act modifies Code §1402(e) to allow any person who has obtained exemption from self-employment taxes under that section to revoke that exemption before he actually receives or becomes entitled to receive benefits under the Social Security Act. In general, however, this revocation will only be available until April 15, 1988.

Section 1882 of the Act modifies Code §1402(g) to clarify that employees of churches and church-controlled organizations may not be exempt from self-employment taxes by reason of religious convictions if the employer is itself exempt from paying employment taxes under FICA. The Act also amends Code §3121(w) to provide for regulations under which a church will be allowed to revoke its election to be exempt from FICA taxes or to lose this exemption if it fails to provide employee wage and salary information as required.

Section 1705 of the Act provides that service in the employment of an Indian Tribal government is not employment for purposes of the Federal Unemployment Tax (Code §3306) if the Indian tribal government is not covered by a state unemployment compensation program on June 11, 1986.

III. Effective Dates

Section 1704(a) of the Act applies to applications for exemption filed after December 31, 1986. Act §1704(a)(3). Sections 1706 and 1882 apply to services rendered and

[22] *See* Employment Tax Regs. §31.3121(d)-1(c)(2).
[23] P.L. 95-600, §530(a)(2).
[24] *See* §§3121(b)(8)(A); 3306(c)(8); 3401(a)(9).
[25] Code §1402(e)(3).
[26] P.L. 98-369, §2603(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

remuneration paid after December 31, 1986. *See* Act §§1706(b) and 1882(b)(3). Section 1705 applies to Indian tribal government which is not covered by a state unemployment compensation program as of June 11, 1986. Act §1705(b).

IV. Detailed Analysis

A. Treatment of Certain Technical Personnel

Before 1978, many businesses which failed to treat certain workers as employees for tax purposes were, on audit, assessed for the employer's share of Social Security and for income tax withholding. These assessments were at times large enough to cause bankruptcies. In response, Congress enacted §530 of the Revenue Act of 1978 [27] which was designed to provide clear rules for determining whether a worker would be treated as an employee or an independent contractor for tax withholding, FICA and FUTA. Section 530 has three main provisions:

(1) to end pre-1979 tax liabilities for employers who had a reasonable basis to treat workers as independent contractors;

(2) to give the same relief prospectively through 1979 for any employer who filed all required tax returns and who did not treat any person with a similar job as an employee for any period after 1977; and

(3) to prohibit I.R.S. issuance of regulations or revenue rulings on common law employment status before 1980.

The second and third provisions were extended indefinitely by TEFRA.[28]

One of the sources for a reasonable basis for treating a worker as an independent contractor was a long-recognized practice of a significant portion of the industry in which a person was employed.[29] As amended by the Act, §530 of the Revenue Act of 1978 no longer applies to any individual taxpayer who provides services as an engineer, designer, drafter, computer programmer, systems analyst or other similarly skilled worker to another person pursuant to an agreement between them.[30] Such taxpayers are to be classified as employees or independent contractors under the generally applicable common law standards for determining classifications. Also, the Treasury is authorized to draft regulations with respect to the employment status of the persons covered by this amendment.[31]

This amendment covers technical personnel whose services are provided by their employers to only one client during a taxable year as well those serving two or more clients. Further, the amendment applies to the specified technical personnel whether they work directly for their employers or through corporations which they control and which formally employ them to provide services to their actual employers. *See* Conference Report at II-834-35.

B. Exemption for Certain Clergy

The Treasury Department is authorized to issue regulations which will specify that any "minister" (minister of a church, member of a religious order or Christian Science practitioner) who seeks exemption from self-employment taxes under SECA must include certain information with his exemption application to the I.R.S.[32] This information must show that the minister has informed his church or religious order of his religious or conscientious objection to social security insurance as required by the regulations. Further, either the Treasury Department (or, by agreement as provided by the regulations, the Department of Health and Human Services) must communicate with the applicant to make its own verification that the applicant understands the grounds on which the exemption is available and that he seeks the exemption on these grounds. The communication may be by mail, telephone or in person so long as the procedure is adequate to ensure the applicant's awareness of the statutory requirements. *See* Conference Report at II-831-832.

For a limited period, ministers who have previously received an exemption under §1402(e) from SECA taxes may make an election to become subject to these taxes and receive Social Security benefits. The election is irrevocable and may only be made (1) before the minister has become eligible to receive benefits under the Social Security Act and (2) before the due date for filing a federal income tax return for the minister's first taxable year beginning after December 31, 1986 (including any extensions to file which he may receive). This election is irrevocable and imposition of SECA taxes for purposes of Social Security benefits will cover earnings after the date of the election. *See* Act §1704(b).

C. Exception for Churches and Church Organizations

Act §1882(a) revises Code §1402(g) to clarify that when a taxpayer who might have been eligible for exemption from self-employment taxation for being a member of a qualifying religious faith is also an employee of a church or church organization which has made an election to be exempt from employment taxes under FICA, he or she may not claim the self-employment tax exemption.[33] Without this provision, it would be possible for both church employer and employee to avoid all employment taxes on the services performed for the employer. This amendment does not restrict the employee's use of the §1402(g) exemption for services to any employer not exempt from FICA taxation. *See* Senate Report at 1071-72.

Under Code §1402(j), added by Act §1882 (b)(1), the employee's remuneration is determined for SECA taxes as it would be for FICA, modified by several special rules. The SECA tax base is determined separately from the tax base for other self-employment income. Therefore, income from church employment will not be reduced by any deductions, while income and deductions arising from other sources will not be affected by any items attributable to church employment. After 1989, however, these taxpayers will be allowed a deduction equal to their net self-

[27] P.L. 95-600.
[28] §269(c), P.L. 97-248.
[29] Revenue Act of 1978, P.L. 95-600, §530(a)(2)(C).
[30] Act §1706(a), amending §530 of the Revenue Act of 1978 by adding subsection (d).
[31] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-834-35 (1986).
[32] Act §1704(a), amending Code §1402(e).
[33] Code §1402(g)(5).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

employment earnings from church sources multiplied by onehalf the SECA tax rate. The threshold for SECA taxation of church employees is $100, applied separately from the standard $400 threshold for income from other sources.

A church or church organization may revoke its election to be exempt from FICA taxation under regulations to be drafted by the Treasury. Act §1882(c), amending Code §3121(w)(2). Moreover, if any church or organization fails to provide the required information on remuneration to employees for two years or more and fails to furnish previously required information when requested by the Treasury, the Secretary must revoke the election. An involuntary revocation will be retroactive to be beginning of the two year period for which the information was not furnished.

D. Application of the Federal Unemployment Compensation Tax to Indian Tribal Governments

The Act provides an exemption from FUTA taxes for services to Indian tribal governments which were not covered by any state unemployment compensation program as of June 11, 1986.[34] This amendment covers services rendered before January 1, 1988, including those performed before enactment of the Act, although there will be no refund of any FUTA taxes already paid. *See* Conference Report at II-833.

[34] Act §1705.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 59

FOREIGN TAX CREDIT: CHANGES AND REFINEMENTS

Harrison B. McCawley, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

Title XII of the 1986 Act,[1] Foreign Tax Provisions, contains seven subtitles dealing with various aspects of the U.S. taxation of foreign income and of U.S. source income earned by foreign or foreign controlled entities. Many of these are interrelated. This area is one of continuing concern and proliferating complexity as the number of multinational enterprises, both U.S. and foreign controlled, and the extent of their activities worldwide increases. This chapter is devoted primarily to the amendments made by the Act to §§902, 904, and 960,[2] all of which relate to the foreign tax credit. The 1986 Act also made numerous changes to other foreign tax provisions which directly affect the new features of the credit rules. These are largely beyond the scope of this chapter, and are discussed fully in Chapters 60-72 of this Section. They will, therefore, be described only briefly with a cross reference to the Chapter providing a more detailed analysis.

The purpose of the foreign tax credit is to eliminate or mitigate double taxation. The U.S. claims primary jurisdiction to impose income taxes on the worldwide income of its citizens and residents as well as the income of foreign nonresidents which is effectively connected with the conduct of a trade or business in the U.S. and certain items of passive income of such persons from U.S. sources. Various foreign governments also impose income taxes on the same income. The U.S. and most of its major trading partners with whom tax treaties are in force have agreed, generally, to the elimination or mitigation of double taxation in such cases through the credit mechanism. There are, of course, other sources of double taxation which the credit mechanism does not effectively reach as well as problems involving primary tax jurisdiction. These are usually dealt with by way of competent authority procedure. The foreign tax credit remains, however, the principal means for the elimination of double taxation. In theory, the credit, which has been part of U.S. tax law since 1918, is a relatively simple tax concept. Where the U.S. has primary tax jurisdiction over a person by reason of citizenship, residence or other jurisdictional connection with the U.S., such person may elect under §901[3] to credit any foreign income, excess profits or war profits tax paid or accrued during the taxable year against any tax imposed by title 1 of the Code. Taxes paid by a foreign corporation of which a domestic corporation owns at least 10% of the voting stock and which distributes dividends to the U.S. shareholder are, under §902, deemed paid by such U.S. shareholder to the extent attributable to the accumulated earnings and profits from which such dividends were paid. In other words, unless and until the foreign corporation's income is subject to U.S. tax by reason of a repatriation of such income, there is no credit allowed under §901. In addition, a deemed paid credit is allowed under §960 with respect to amounts included in the gross income of a U.S. shareholder of a controlled foreign corporation (CFC) under §951 (so called subpart F inclusions).

The credit mechanism itself is complex due primarily to the fact that the various foreign tax authorities impose different kinds of taxes on different kinds of income at different rates and under different basic concepts of taxation than those generally prevailing under the U.S. system. It is, thus, virtually impossible to mesh the U.S tax regime with that of another country with a high degree of precision.

Fundamental to the allowance of a credit for foreign taxes is the rule, first enacted in 1921, that the amount of the credit is limited to the amount of U.S. tax imposed on the item of income on which the foreign tax was imposed. Thus, if the U.S. tax rate on an item of $100 of foreign income is 34% and the foreign effective rate is 45%, the U.S. credit is limited to $34. If a credit were allowed for the full amount of foreign tax, $11 would be available to offset U.S. tax on other items included in U.S. income. In other words, the U.S. would subsidize the taxpayer's liability for foreign taxes imposed at an effective rate higher than the U.S. rate. This is not the purpose of the credit. Limitation of the amount of foreign tax credit allowable for a given taxable year is effected under §904(a), by restricting the credit to an amount equal to the U.S. tax imposed for the year on taxable income from all sources multiplied by a fraction the numerator of which is the taxpayer's taxable income from all foreign sources and the denominator of which is taxable income from all sources. This is referred to as an overall basis limitation. Beginning in the

[1] P.L. 99-514, the Tax Reform Act of 1986, herein referred to as the "1986 Act" or the "Act."

[2] All references to sections herein refer to sections of the Internal Revenue Code of 1986 unless otherwise specified.

[3] Where no election is made, foreign taxes may qualify as deductions under §162 or 164.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

1960's, after a post-War period during which the foreign tax credit provisions provided a number of incentives to foreign investment, Congress has substantially revised the credit rules with tax neutrality as the goal. The 1986 Act amendments about to be discussed may be seen as a continuation of this program. Underlying many of the foreign tax provisions of the 1986 Act is the awareness that its lowering of U.S. tax rates will exert pressure on U.S. taxpayers to avoid, insofar as planning permits, the generation or expiration of excess credits (*i.e.*, credits earned in excess of the amount allowable under the §904 limitation). The principal objective of the credit reform measures is the fine tuning of the limitation provisions to minimize opportunity for abusive manipulation and to prevent revenue loss from various flaws and anomalies in the existing rules.

At the core of most of the amendments to be discussed is the problem of credit averaging or cross-crediting. Given two items of foreign income distinct either by reason of character or source, one subject to an effective foreign tax rate lower than the U.S. rate, and the other subject to a rate higher than the U.S. rate, should the §904 limitation be applied separately to each item, or should they be combined for limitation purposes? One approach is to provide a separate limitation for income sourced in each foreign country. Such a per country limitation was either mandated or allowed under U.S. law for many years [4] but was finally dropped in 1976 because under a per country rule, a net loss sustained from sources in one country is applied directly to offset U.S. taxable income notwithstanding the allowance of credits for taxes imposed on income sourced in another country or other countries. This was seen as involving "double tax benefits" in the absence of a loss recapture rule, particularly where the loss country did not have a provisions similar to the U.S. net operating loss carryover.[5] Congress both repealed the per country limitation and adopted the loss recapture rules of §904(f) to deal with this problem. As a result, since 1976, §904 has been applied on an overall basis.

This, however, did not completely solve the problem outlined above. In lumping together income subject to high effective foreign rates and income subject to very low or no foreign taxes, the limitation provisions permitted the averaging of foreign rates. If total taxable income is 1000 of which 100 is subject to a foreign tax of 60 and 100 is foreign income subject to no tax, assuming a U.S. tax rate of 34%, all of the foreign tax may be credited against the U.S. tax on the foreign income of 68, leaving the U.S. with a residual tax of 8. Does this result violate the intent and purpose of the credit provisions, or are there circumstances under which the limitation should be applied separately to separate and discrete items of foreign income on some basis other than the country of source.

The question posed is not easily answered. It involves a number of complex issues of tax policy. If the 100 of untaxed foreign income was deliberately generated for the purpose of cross crediting, there is ground for imposing a separate limitation with respect to such income. If, for example, the U.S. taxpayer shifts investment funds from the U.S. or a foreign jurisdiction with tax rates similar to those of the U.S. to a tax-haven country, the net effect, or so it is viewed by Congress, is to abuse the credit mechanism by compelling the U.S. Treasury to subsidize foreign taxes imposed on other income at a rate or rates in excess of the U.S. rate. On the other hand, where there is no deliberate manipulation of the income source, as in a case where both items of taxable income are from countries in which business operations are actively carried on by a multinational domestic corporation, there is considerably less objection to averaging.

The first appearance of a separate limitation was in 1962 when it was required for "passive interest." [6] Such interest is easily manipulable, that is, can be generated in virtually any foreign country, and, further, is usually subject to low (or no) foreign taxes. By inflating the numerator and denominator of the limitation fraction, increasing its value, passive interest, if not subject to a separate limitation, could result in abusive averaging. Another separate limitation provision was enacted in 1975, providing special treatment under §907 for foreign oil related income. Per-country based limitation of the credit allowable for taxes on such income was prohibited. Instead, a separate overall limitation was applied to these taxes, with a provision for the recapture of losses sustained from such activity.[7] In addition to these items, separate limitations were subsequently required for DISC and former DISC dividends, foreign trade income of a FSC (foreign sales corporation) and distributions of a FSC or former FSC attributable to foreign trade income.[8] All of these items bear little, if any, foreign taxes.

Other problems are encountered in applying the deemed paid credit of §902 due to the dichotomy that exists between the credit mechanism as applied to foreign operations carried on directly or through a branch and those carried on through a foreign subsidiary. In respect of the latter, Congress eliminated the deferral of U.S. tax on various types of income earned by a subsidiary by taxing such it currently under the provisions of §§951-956 (generally referred to as the "subpart F" rules) as if it had been earned by a branch, with an appropriate deemed paid credit provided by §960. In contrast, the deemed paid credit allowable with respect to dividends distributed by a foreign corporation out of earnings not previously taxed by the U.S. to a 10% or more domestic corporate shareholder under

[4] The legislative history of the limitations provisions prior to 1976, when the present §904 rule was adopted, deserve brief mention. The original 1921 limitation was imposed on an overall basis. In 1932, the limitation was the lesser of that computed on an overall basis or a per country basis. In 1954, the limitation provisions were changed to utilize only the per country basis. In 1960, the law was again amended to allow the limitation to be computed on either basis. Finally, in 1976, present law was adopted mandating the use of an overall limitation.

[5] H.R. Rep. No. 658, 94th Cong., 2d Sess. 230 (1976) at 225.

[6] §904(d)(1)(A) as in effect prior to the 1986 amendments.

[7] Under present law, §907, unaffected by the 1986 Act, provides for (1) reducing the amount of foreign taxes paid on foreign oil and gas extraction income for all credit purposes by the excess of such taxes over the maximum which would be imposed under §11 (another reduction formula applies to individuals), and (2) in the case of oil related income, the limitation of creditable foreign taxes to an amount not materially greater than the foreign taxes imposed on income other than oil related or oil and gas extraction income; foreign taxes in excess of this amount are treated as deductions under foreign law.

[8] §904(d)(1)(B), (C), and (D) as in effect prior to the 1986 amendments, now redesignated as (F), (G), and (H).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

§902 often involves distortions, some favoring the taxpayer and some the Government, since the credit can be computed only by tracing the dividends to the earnings and profits from which paid. The fluctuations of foreign tax rates and rules from year to year sometimes place a premium on the precise timing of distributions offering special tax advantages to those who can manipulate them. In addition, net losses of the foreign corporation are carried back until exhausted for credit purposes with the result that credits for foreign taxes paid for years whose earnings and profits are eliminated under this rule may be lost forever. These problems were also attacked in the 1986 amendments.

As noted above, the foreign loss recapture rule of §904(f) was adopted in 1976. In effect, it is a change of source rule rather than a recapture rule, designed to insure that a foreign loss incurred in one year that reduces U.S. taxable income will be taken into account in a succeeding year to prevent what in effect is an unjustifiable credit. Prior to the rule, where a $100 foreign loss in year 1 reducing U.S. taxable income in that amount was followed by foreign gain of $100 in year 2 which, due to the lack of a counterpart of the U.S. net operating loss carryover rules, was fully taxed, a credit for the Year 2 foreign tax was allowed in full, even though, due to U.S. tax law, there was no net foreign income from Years 1 and 2 combined. The effect was viewed by Congress as tantamount to allowing a credit for a tax imposed on foreign income excluded from U.S. taxable income. The 1976 changes required the treatment of subsequent foreign income up to the amount of the loss as U.S. source income, reducing the limitation fraction numerator and, thereby, reducing the credit allowable. Under the prior separate limitations provisions, it was unclear how this recapture rule was to operate where a loss was sustained in one separate limitations category where there was overall foreign net income. Congress concluded that this required legislative clarification.

A number of the changes made to the credit provisions are directed to the prevention of abuse effected primarily by the manipulation of foreign income sources. A number are intended to protect U.S. tax revenues from subsidizing unduly foreign taxes imposed at rates substantially higher than U.S. rates (which are lowered by the 1986 ACT) The reform of the limitations provisions will result in many instances in the loss of immediately available credits, and quite possibly the inability to utilize any excess credits eligible for carryover before their expiration. It is too soon to judge the extent to which the effect of the restrictions will discourage foreign operations or simply render them less profitable after taxes. These effects may be offset to some extent by revisions by some of the U.S. trading partners of their own rates.

In this chapter are discussed three major areas of change, namely (I) the expansion of the separate limitations categories or "baskets," (II) the revision of 902 to provide an accumulated basis for the deemed paid credit, and (III) the clarification of the rules relating to separate limitation losses. There are also noted (IV) the legislative enactment of existing regulations regarding the noncreditability of taxes used to provide subsidies and limitations placed on the carryback of excess credits to pre-1987 years.

II. The Extension of Separate Limitations Categories

A. Background and Legislative History

Some of the legislative background of the separate limitations provisions of §904(d) as in effect prior to the 1986 changes has been set forth above. The separate limitation under §904(d)(1)(A) prevented use of easily manipulable passive interest bearing low foreign taxes artificially to inflate the §904 overall limitation fraction's value. Similar reasons support the separate limitations under §904(d)(1)(B), (C) and (D) for DISC and FSC income. Under prior law, passive interest (not a term used in the Code provisions) is interest defined by §904(d)(2) as any interest other than that derived from any transaction directly related to the active conduct by the taxpayer of a trade or business in a foreign country or possession or derived from the carrying on of a banking, finance or similar business. Also excluded is interest from a corporation in which the taxpayer (or any member of a consolidated group of which it is a member) owns at least 10% of the voting stock, or which is derived from obligations acquired from the disposition of an active foreign business or such 10% or more owned corporation. Paragraph (3) of §904(d) provides a look through rule under which dividends or interest paid by a "designated payor corporation" and attributable to any taxable year of the corporation are treated as passive interest to the extent that the aggregate amount of the dividends and interest do not exceed the payor's passive interest income for the year, reduced by the payor's deductions properly allocable to such interest. If the payor's net passive interest so determined does not exceed 10% of its earnings and profits for the year, it is deemed, under the *de minimis* rule of §904(d)(3)(C), not to have any passive interest.

Under the separate limitation rules, foreign taxes imposed on the foreign income in each separate limitation basket, or "category" in the terminology of the new provisions, may be credited against U.S. taxes imposed on the same income, but not against U.S. taxes imposed on income falling in other categories. Under separate limitations rules, foreign income is included either in one of the enumerated special separate categories or falls in the general overall category.

Experience with the foreign tax credit limitations provisions over the years convinced Congress that a number of amendments to 904 were called for. Under the overall limitation formula, leaving aside the separate limitations items enumerated, taxpayers could still obtain substantial tax advantages by averaging high and low foreign taxes. In many cases, the averaging effect, insofar as it did not result from essentially passive income, and did not result from manipulation by the U.S. taxpayer of foreign rates or foreign sources, merely reflected the fact that multinational operations involve a wide variety of tax regimes and rates. To this extent, Congress did not find such averaging or "cross-crediting" objectionable.[9]

On the other hand, the inclusion in the overall basket of certain types of foreign source income which (1) because of

[9] *See* S. Rep. No. 313, 99th Cong., 2d Sess. (1986), hereinafter referred to as "S. Rep.," at 302-303.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

its passive nature is easily manipulable as to source, and/or (2) bears unusually high tax rates, or (3) is subject to unusually low or no tax, was considered to result in averaging or cross crediting contrary to the basic intent and purpose of the limitation provisions. Not only was there a loss of tax revenue, but the tax advantages obtained provided incentives for the placing of new investments abroad in low tax countries instead of in the U.S. Such incentives would be exacerbated by the Act's reductions of U.S. tax rates.[10] These are the principal factors which led Congress to refine §904(d) by the addition of new separate limitation categories.

This problem existed with respect to both the "direct" credit allowed under 901 and the "indirect" or deemed paid credit allowed under 902 and 960 (for subpart F inclusions). With respect to the indirect credit for foreign taxes paid on income subject to separate limitations earned by U.S. controlled foreign corporations, a look-through rule was deemed appropriate similar to the look through provisions of §904(g), enacted by the 1984 TRA, maintaining the source of U.S. source income earned by U.S. owned corporations, and following to some extent, but with numerous modifications, the look through rules of §904(d)(3), also a 1984 TRA amendment, discussed above.

On the other hand, dividends and other payments from noncontrolled (more than 10- but not more than 50% U.S. owned) corporations in which the taxpayer owns sufficient stock to be eligible for allowance of a deemed paid credit under §902 were not viewed as properly subject to look through principles. One reason was the relative difficulty of the U.S. taxpayer in obtaining the information required to apply the look through rules. Another was that there is insufficient tax neutrality justification for treating such corporations consistently with the treatment of branches, as in the case of CFC's. It was thought more appropriate to place all dividends from such noncontrolled corporations, whatever the character of the earnings from which paid, in a separate limitation category on a corporation by corporation basis since there was no basis for permitting the cross crediting of taxes on income from controlling interests in foreign corporations against taxes on income from noncontrolling interests or from one noncontrolling interest against another noncontrolling interest. The Committee Report [11] states that the look through rule would not have been eliminated for such corporations, however, without the Act amendments providing for the inclusions in income of U.S. shareholders of passive foreign investment companies (PFIC's) under new §§1291-1297 of passive income earned by such corporations. As is discussed in Chapter 64, *infra*, PFIC income is included in the definition of passive income for separate limitation purposes and thus there will be little opportunity for the cross-crediting of taxes on income from active business activities against taxes on the income of noncontrolled foreign corporations whose income is predominantly passive.

It has been seen that while the amendments to §904 are declared to be needed to stem certain forms of tax avoidance, Congress was also motivated to some extent by certain nontax goals; disincentives to choosing foreign over U.S. investment, for example. Another example is found in the general exclusion from these separate limitation categories of foreign source interest derived from the financing of goods manufactured, grown, extracted, etc, by the taxpayer or a related person for export to or use in a foreign country. On the other hand, while most of the separate limitations categories involve low taxed income, it was thought necessary to segregate and provide special treatment for interest subject to abnormally high withholding taxes which are born to a large extent by foreign borrowers and result, in most instances, in the absorption by the credits generated of all U.S. tax on the net interest income and the application of the remaining excess credits against U.S. taxes on other income. Such high withholding tax advantages were seen as providing a strong incentive to lending to certain foreign persons since, by reason of the cross crediting of the high taxes, these loans would yield a higher after-tax return than loans made to U.S. borrowers.

B. Overview

1. The New Separate Limitation Categories

Section 1201 of the Act amends §904(d)(1) providing for separate limitation categories of foreign income, by (1) striking out paragraph (A) (relating to passive interest), and (2) redesignating paragraphs (B),(C),and (D) (relating to DISC and former DISC dividends and to certain FSC income) as paragraphs (F), (G) and (H), and paragraph (E), the overall category, as (I). There are then added five new categories of separate limitation income:

(A) passive income

(B) high withholding tax interest

(C) financial services income

(D) shipping income, and

(E) dividends from each noncontrolled §902 corporation.

2. Passive Income

Passive income is defined in §904(d)(2)(A) [12] as any income received by either a U.S. person or a foreign person which is *of a kind* that would be foreign personal holding company income as defined by §954(c). That is, income which would constitute foreign personal holding company income includible as foreign base company income in the hands of a CFC. This will be referred to herein as subpart F FPHC income, since §954(c) defines one of the five types of foreign base company income (FPHC, sales, services, shipping and oil related) included in subpart F income under the definition of that term in §952(a). Also included is foreign personal holding company income includible in income under §551 (*i.e.*, FPHC income as defined by

[10] *See* H. R. Rep. No. 426, 99th Cong., 2d Sess. (1985), hereinafter referred to as "H.R. Rep," at 333.

[11] Conf. R. No. 99-841, 99th Cong., 2d Sess. (1986), hereinafter referred to as "Conf. R.," at II-583.

[12] Prior law paragraphs (2) and (3) of subsection (d) (relating to passive interest inclusions) are stricken out).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

§553) [13] and amounts includible in gross income under §1293 (relating to foreign passive investment companies).[14]

Passive income does not include income subject to any of the other enumerated separate limitation categories ((B) through (E), *supra*). There are also excepted from passive income the following three items: [15]

Export Financing Interest;

High-Taxed Income;

Foreign Oil and Gas Extraction Income.

a. Export Financing Income

Export financing income receives special treatment throughout the Act's amendments to foreign tax provisions. It is defined as any interest derived from financing the sale (or other disposition) for use or consumption outside the United States of property manufactured, produced, grown or extracted by the taxpayer or a related person. Such property does not qualify if more than 50% of its fair market value (*i.e.*, its appraised value under §402 of the Tariff Act of 1930 (19 U.S.C. 1401(a)) is attributable to imported property.[16] As will be seen below, export financing income is not only excluded from the passive income category, but is also excluded from the separate limitation categories for high withholding tax interest and financial services income.[17]

b. High-Taxed Income

High taxed income is income that would otherwise be included as passive income, if the sum of the foreign income taxes (*i.e.*, taxes of the same type for which a credit is allowed under §902) paid or accrued by the taxpayer, and taxes deemed paid under §§902 or 960 by such taxpayer, exceeds the highest rate imposed by §1 or §11 (whichever applies) multiplied by the amount of such income (as grossed up under §78 where applicable). The exclusion of high taxed income from the passive income category is referred to in the Conference Committee report as the "high tax kick out."

The committee reports make it clear that in determining the effective rate of foreign tax, the expenses, losses and deductions of the U.S. recipient must be allocated to such income.[18] It is also made clear that the high tax kick out applies at the U.S. level only.[19] For further discussion of this rule, see the analysis in C, *infra*.

As noted, high taxed foreign income is income that, without the kick out, would be passive income. Where excluded, it will fall into the overall limitation category. It is not excluded from the other types of separate limitation income. Note that the same item can be both high withholding tax interest and high taxed income. In that case, in it is included in the high withholding tax separate limitation category and, for this reason, is excluded from financial services income, discussed below.

c. Foreign Oil and Gas Extraction Income

As noted above, foreign oil and gas extraction income is subject to its own special limitations rules provided under §907. These, as last amended by P.L. 97-248 (TEFRA) and P.L. 97-448 (Technical Corrections Act of 1982), will not be discussed herein.

3. High Withholding Tax Interest

The 1986 amendments place high withholding tax interest in a separate category and, in effect, separates it from all other types of interest (excepting export financing interest) [20] for limitation purposes. It is, therefore, not includible in other separate limitation categories (with the exception of shipping income) [21] and, for this reason, receives special treatment somewhat similar to that accorded oil and gas extraction income. Consequently, the withholding tax can be credited only against U.S. tax on the net interest includible in taxable income for tax credit limitation purposes (*i.e.*, gross interest reduced by the U.S. recipient's deductions allocable thereto). It is defined as any interest subject to a withholding tax (or other tax determined on a gross basis) imposed by a foreign country or U.S. possession where the rate is at least 5%.[22] Further, regulations are authorized under which other amounts may be treated as high withholding tax interest "where necessary to prevent avoidance of the purposes of this subparagraph." [23]

For purposes of determining the deemed paid credit under §902, high withholding tax interest paid by a noncontrolled §902 corporation, discussed in 5. below, is not

[13] Prior to the 1986 Act amendments, §954(c)(1) defined FPHC as consisting of the same items set forth in §553 with the modifications contained in paragraphs (2), (3) and (4). As amended, §954(c) omits reference to §553, and contains its own list of includible items with exceptions and special rules. These, as amended by the 1986 Act, as is explained in Chapter 63, *infra*, include (A) dividends, interest, rents, royalties, and annuities — excepting (1) active business derived rents and royalties from unrelated persons, and (2) dividends and interest from a same country related person and rents and royalties from a related person for use of property in the same country; neither of these exceptions ((1) and (2)) applies where payment reduces the payor's subpart F income, (B) gains over loss from sales of property generating passive (or no) income, (C) commodities gains over losses (including futures) unless they are hedges or incurred by a commodities dealer, (D) foreign currency gains over losses not related to business needs, (E) income equivalent to interest (commitment fees, etc.).

[14] §904(d)(2)(A)(ii). The new FPIC provisions are discussed in Chapter 64, *infra*.

[15] §904(d)(2)(A)(iii)(II), (III), and (IV).

[16] §904(d)(2)(G). A "related person" for this purpose has the same meaning given the term by §954(d)(3), also amended by the Act (*See* Chapter 63, *infra*), with one modification, as will be more fully explained below.

[17] Among the 1986 Act's amendments to §954(c)(defining FPHC for subpart F purposes) is the termination of the exclusion under prior law from PFHC income of interest derived from the carrying on of a banking, finance or similar business; such interest is now includible in foreign base company income and taxable under subpart F. However, §954(c)(2)(B) provides that PFHC does not include interest derived from banking which is export financing interest as defined by §904(d)(2)(G).

[18] Presumably, under Regs. §1.861-8. *See* Conf. Rep. at p. II-567-8.

[19] *Id.* at p. II-568.

[20] §904(d)(2)(B)(ii).

[21] Income which is both subpart F FPHC income (which includes all interest except that paid by a same country related person whose payments do not reduce its subpart F income) and shipping income is treated as shipping income for limitations purposes. Conf. Rep. at II-565. There is no statutory exception from shipping income of interest, high withholding or other. If includible as shipping income under §954(f), high withholding interest is apparently included in the shipping income category.

[22] §904(d)(2)(B)(i).

[23] §904(d)(2)(B)(iii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

treated as a foreign tax to the extent the tax rate exceeds 5%.[24] However, it is separate limitation income in the hands of a CFC subject to the look through provisions of §904(d)(3), discussed below.[25]

The effective date provisions of Act §1201(e) contain complex transitional rules relating to the treatment of interest as high withholding tax interest where such interest is paid with respect to loans made to residents certain developing countries. These will be discussed in C, of the Detailed Analysis below.

4. Financial Services Income

In the House version of the separate limitation provisions, a separate limitation was created for banking and insurance income. The Senate version provided for no separate limitation for such income. The treatment for limitations purposes, of income from banking, financing and similar services and from insurance takes into consideration the amendments made to §954(c) defining personal holding company income for subpart F inclusion purposes. Under prior law §954(c)(3), dividends, interest, and gains from the sale of stock and securities, which would otherwise be FPHC income, derived by banks in the conduct of a banking business was generally excluded from FPHC income as was the same type of income derived by an insurance company from investment of unearned premiums and required reserves, so long as such income was not received from a related person. Under §954(c), as revised by the 1986 Act, there is no similar exclusion. Therefore, without a separate limitation for financial services income, the income of a bank or insurance company would generally be either passive income or overall limitation income. Financial services income, as defined by §904(d)(2)(C) for separate limitation purposes, means income which is not passive income determined without regard to subparagraph (A)(iii)(I). This subparagraph excludes from the term "passive income" income falling into categories (B) through (E), *i.e.*, high withholding interest, financial services income, shipping income, and dividends from noncontrolled §902 corporations. In other words, there is excluded from the category financial services income [26] all items of subpart F FPHC income, §551 FPHC income, and §1293 PFIC income, excepting only export financing interest, high taxed income and foreign oil and gas extraction income. Thus, financial services income excludes, generally, such items as interest, dividends, rents and royalties from unrelated persons, gains from the sale of property generating passive income (or no income), commodities futures and foreign currency transactions gains. It *does include* income derived in the active conduct of a banking, financing or similar business, or derived from the investment by an insurance company of its unearned premiums and ordinary and necessary reserves.[27] Also included is insurance income of the kind defined in §953(a)(as amended by the Act) and also includes insurance income from the same country in which the insurance company was organized or created.

The Conference Committee points out that the term "financial services income" (substituted for the House's "banking and insurance income") is intended to indicate the breadth of the term's scope which, in the case of banks, includes income attributable to the activities listed in present Regs. §1.954-2(d)(2)(ii)(A) plus various kinds of income generally associated with and realized by persons carrying on banking and financing businesses, including fees and charges for a wide variety of bank or financial services. However, rentals or fees charged for the use of a bank's property, essentially passive income, would not be included.[28] Also included is income of captive offshore insurance companies subjected to current taxation under the 1986 Act amendments to §953(c).

A special rule is provided for entities "predominantly engaged" in a banking, insurance, financing, or similar business.[29] Regulations will set forth the criteria for determining whether an entity is "predominantly engaged" in such activities, based on guidelines provided by the Conference Committee report, discussed in the detailed analysis at C, *infra*.

Under this special rule, financial services income *includes passive income* (including, for this purpose, passive shipping income and dividends from noncontrolled §902 corporations). The statute clarifies that in this case, the term "shipping income" does not include any income characterized as financial services income. Thus, if an item of income received by a corporation predominantly engaged in banking is both passive income and shipping income, it is classified as financial services income.

Both export financing interest and high withholding interest are excluded from financial services income irrespective of whether the "predominantly engaged" qualification is met.[30]

5. Shipping Income

For purposes of the separate limitations provisions, the term "shipping income" means income of a kind which would be foreign base company shipping income under §954(f) (as amended by the 1986 Act).[31] Such shipping income includes both passive items and items derived from the active conduct of a shipping business. All are swept into this category, as a general rule, if they are described in §954(f) even though some may also qualify as some other category of separate limitation income. One exception is passive shipping income of a person predominantly engaged in banking, insurance, financing, etc., as noted above.

6. Dividends From Noncontrolled §902 Corporations

The last category of separate limitation income added by the 1986 amendments is dividends from a noncontrolled foreign corporation with respect to which the taxpayer meets the stock ownership requirements of §902(a) (or, for purposes of applying §904(d)(3) (the look through rules, discussed below), the requirements of §902(b)).[32] This sepa-

[24] §904(d)(2)(E)(ii).
[25] Conf. Rep. at p. II-587.
[26] The statute is somewhat circuitous in this respect. Interest derived from a financing business is passive income as defined without the financial services exception and is, therefore, excluded from the general definition of financial services income provided by §904(d)(2)(C)(i).
[27] §904(d)(2)(C)(i)(I).
[28] Conf. Rep. at II-570.
[29] §904(d)(2)(C)(ii).
[30] §904(d)(2)(C)(iii) and (iv).
[31] §904(d)(2)(D).
[32] §904(d)(2)(E).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

rate limitation category includes only dividends paid out of earnings and profits for any period during which the distributing corporation was not a "controlled foreign corporation." [33]

Under §902(a), a deemed paid credit is allowed to any domestic corporation which owns 10% or more of the voting stock of a foreign corporation from which it receives dividends in any taxable year. Under §902(b), where such 10% or more owned corporation (the first tier corporation) owns 10% or more of the voting stock of a second corporation from which it receives dividends, the first tier corporation is deemed to have paid the same portion of the second corporation's foreign taxes as it would under §902(a) if the first tier corporation were a domestic corporation. A similar deemed paid rule applies to taxes paid by a third tier foreign corporation 10% or more of whose stock is owned by the second tier corporation.

This limitation is applied on an entity by entity basis. Its operation in conjunction with the look through rules is discussed below. The exclusion, for deemed paid credit purposes, from treatment as foreign taxes of high withholding taxes paid on interest by a noncontrolled §902 corporation to the extent they exceed 5% of gross interest was discussed above.

7. Related Person

For purposes of paragraph (2) of §904(d), a "related person" has the meaning given such term by §954(d)(3), substituting "the person with respect to whom the determination is being made" for "controlled foreign corporation" each place it appears.[34] The term "related person" is used in the provisions discussed above only in defining export financing interest.[35] Section 954(d)(3) was amended by the 1986 Act. Applied under §904(d)(2)(H) in its amended form, a corporation is related to another corporation if one controls the other or if both are controlled by the same person. For this purpose. "control" means ownership of *50% or more* of the voting power of all stock entitled to vote or of the total value of all stock outstanding.[36] Note that the definition of "controlled foreign corporation" in §957(a), as amended by the 1986 Act, for subpart F purposes, requires ownership by U.S. shareholders of *more than 50%* (more than 25% in the case of certain insurance companies under §957(b)) of the voting power or value of the CFC's stock. The House bill provided a 50% or more threshold, but this was not in the Senate or Conference bill. A "U.S. shareholder," in turn, is defined by §951(b) means a U.S. person who owns 10% or more of the voting power of a foreign corporation's stock. This definition was not amended by the Act.

8. Transitional Rule

Section 904(d)(2)(I) provides a transitional rule. Under it, taxes paid or accrued in a pre-1987 taxable year on passive interest separate limitation income under the pre-amendment §904 provisions (§904(d)(1)(A)) are treated as taxes paid on passive income as defined by §904(d)(1)(A) of the amended statute.[37] Taxes paid or accrued in a pre-1986 taxable year with respect to overall limitation income under the pre-amendment §904 provisions (§904(d)(1)(E)) are treated as paid or accrued with respect to overall limitation income under the amended statute (§904(d)(1)(I)), except to the extent that the taxpayer can establish that the taxes were paid on shipping income or, in the case of an entity predominantly engaged in a banking, insurance, financing, etc. business, it is established that the taxes were paid with respect to financial services income.[38] Lastly, taxes paid or accrued pre-1987 with respect to any other category of separate limitation income under the pre-amendment §904 are treated as paid with respect to the corresponding category under the amended statute. These rules apply to excess credit carryovers to be applied on a separate limitation by separate limitation basis.

9. The Look-Through Rules

a. Introduction

As noted above in the general background remarks, Congress concluded that there should be consistency between the application of the separate limitation rules in the case of income earned directly by a foreign branch or other entity and income earned through a controlled foreign corporation. The same considerations led to the adoption of a look-through rule provided by §904(d)(3) under prior law with respect to separate limitation passive interest. A look-through rule is also provided by §904(g) (relating to the maintenance of U.S. source with respect to dividends and interest paid a CFC with U.S. source income) The Conference Committee adopted what was essentially the Senate version of look through principles, embodying the basic technique of the former §904(d)(3) and the §904(g) source maintenance provisions, with substantial modifications. In their final form, these rules are simpler than those provided by the Senate bill due, in large measure, to the decision to make the rules as consistent as possible with those relating to subpart F income. An analysis of the House and Senate versions will help in understanding these rules, and will be set forth in the detailed analysis in C. below.

b. Dividends, Interest, Rents and Royalties; Subpart F Inclusions

(1) In General

The general rule of §904(d)(3)(A) is that dividends, interest, rents and royalties received or accrued by the taxpayer (and which would usually constitute separate limitation passive income) from a CFC of which the tax-

[33] A controlled foreign corporation, for purposes of these provisions, is defined by §904(d)(4)(A) as having the meaning given the term by §957 (taking into account §953(c)). Under §957(a), as amended by Act §1222(a), control exists where U.S. persons own more than 50% of the voting power of all classes of stock or of the total value of all stock outstanding. Section 957(b) provides a special definition of control for purposes of taking into account insurance income described in §953(a); control exists if U.S. persons own more than 25% of the foreign corporation's stock (voting power or value). The same definition of control is provided by §953(c) (relating to captive insurance companies). The Committee Report in discussing such noncontrolled §902 corporations refers to them as 10 to 50% U.S. owned, but the statute definitely makes provision for more than 25% U.S. ownership control in the case of insurance income.

[34] §904(d)(2)(H).

[35] §904(d)(2)(G).

[36] §954(d)(3).

[37] §904(d)(2)(I)(i).

[38] §904(d)(2)(I)(ii)(I) and (II).

payer is a U.S. shareholder [39] shall not be treated as income in a separate category.

Paragraph (B) provides that any amount included in income under §951(a)(1)(A), that is, basically the U.S. shareholder's pro rata share of the CFC's subpart F income (but *not* its investment in U.S. property which is includible under §951(a)(1)(B)), shall be treated as income in a separate category to the extent the amount so included is *attributable to* income in such category. Section 904(d)(3)(G) makes it clear that amounts includible under §951(a)(1)(A) include any §78 gross up attributable to such inclusion.

Under paragraph (C), it is provided that any *interest, rent or royalty* (but not dividend) received or accrued from a CFC in which the taxpayer is a U.S. shareholder is treated as income in a separate category to the extent it is properly *allocable* (under regulations prescribed by the Secretary) to income of the CFC in such category.

Dividends paid out of the earnings and profits of a CFC to a U.S. shareholder (including amounts includible in income under §951(a)(1)(B), relating to amounts invested in U.S. property),[40] are treated as income in a separate category *in proportion to the ratio* of the portion of the earnings and profits *attributable to* income in such category, to total earnings and profits.

Note: To fully understand these rules and the source or interest netting rule of §904(c), to be discussed below, it must be borne in mind that in determining taxable income from sources without the U.S. for the purpose of computing the amounts included in the §904 limitation formula, Regs. §1.861-8 require the apportionment and allocation of the U.S. taxpayer's deductions, losses and expenses (referred to as "deductions") to each item of such income. Similarly, in determining the amount of foreign base company income includible in gross income of th U.S. shareholder of a CFC, §954(b)(5) requires that the CFC's expenses, including taxes, be allocated to such income. Regs. §1.861-8 are to be applied for this purpose as well.[41] The term "allocable (under regulations prescribed by the Secretary) to income of," or similar terminology, where used in the provisions under discussion, refers to the Regs. §1.861-8 allocation rules. The House committee report contains an example of the allocation process:

> *Example:* A wholly owned CFC earns $85 of gross income consisting of $60 from manufacturing in its country of incorporation and $25 of interest on a loan to an unrelated foreign person. The manufacturing income is not subject to a separate limitation. The interest income is separate limitation passive income. The CFC incurs expenses of $115 of which $85 are attributable to manufacturing and $30 is interest paid to its U.S. owner. The CFC thus has a net operating loss of $30. It owns assets worth $500 of which $300 are manufacturing assets and $200 is a receivable from the foreign debtor. To determine how much of the $30 in interest paid to the U.S. owner is treated as separate limitation passive income, the payments must be allocated to gross separate limitation passive income and gross overall limitation income of the CFC. The asset method is used to allocate interest. Thus, $18 of the interest paid ($30 × $300 ÷ $500) is allocated to the CFC's $60 of gross manufacturing income and $12 of the $30 interest paid allocated against the CFC's $25 of interest income. As a result, $12 of the $30 interest payment to the U.S. parent is treated as separate limitation passive income.[42]

The term "attributable to" implies identification with a specific item of income, essentially a tracing process. The reason that inclusions under §951(a)(1)(B) (investments in U.S. property) are treated as dividends for purposes of the look through rules is that it is impossible to identify such inclusions with or trace them to any specific items of income of the CFC.[43]

(2) Subpart F Rules Applied

Section 954(b)(3)(A), as amended by §1223 of the Act, provides that if the sum of foreign base company income (before allocations required by §954(b)(5)) is less than the lesser of (i) 5% of gross income or (ii) $1,000,000, then no part of gross income for the taxable year is treated as foreign base company income, the so-called *de minimis* rule. Paragraph (B) provides that where the foreign base company income plus gross insurance income for the year exceeds 70% of gross income, the entire gross income for the year is treated as foreign base company or insurance income, whichever is appropriate.

It was concluded that the *de minimis* rule (but not the more than 70% rule) should be incorporated into the look through provisions. Section 904(d)(3)(E) provides that where a CFC meets the requirements of §954(b)(3)(A), for any taxable year, then *none* of its income for the year is treated as income in a separate category. It follows from this that where the *de minimis* rule applies, dividends, interest, rents and royalties paid or accrued by a CFC to a U.S. shareholder are automatically treated as overall limitation income. The Conference Committee report states, ". . . the subpart F *de minimis* rule also functions as a *de minimis* rule for the separate limitations for passive, financial services, and shipping income, and the separate limitations for high withholding tax interest . . . and dividends from a 10- to 50% U.S. owned foreign corporation." [44] On the other hand, where the CFC's foreign base company

[39] *See* definitions of CFC and U.S. shareholder in §§957(a) and 951(b).
[40] §904(d)(3)(G).
[41] *See* Regs. §1.861-8(f)(1)(i) and (v), and Regs. §1.954-1(c) which provide that "expenses, taxes and deductions shall first be allocated to items or categories to which they directly relate; then expenses, taxes and other deductions, which cannot be definitely allocated to some item or category of gross income shall be ratably apportioned among all items of categories of gross income, except that no item of expense, tax or other deduction is to be allocated to an item or category to which it clearly does not apply." *See* H.R. Rep. at p. 342; S. Rep. at p. 318.
[42] H.R. Rep. at p. 342-343. The identical example is set forth in the Joint Committee's General Explanation of the Revenue Provisions of DEFRA (1984 TRA), December 31, 1984 explaining the provisions of §904(g)(3) which requires that interest paid by a U.S. owned foreign corporation to a U.S. shareholder or related person to such shareholder is U.S. source income to the extent it is "properly allocable (under regulations prescribed by the Secretary) to income of [the CFC] from sources within the U.S." General Explanation at p. 349-50.
[43] *See* S. Rep. at p. 315.
[44] Conf. Rep. at II-574-575.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

income exceeds 70% of its gross income, this fact will have no effect on the operation of the look through principles.

Another subpart F rule, §954(b)(4), as amended by §1221(d) of the Act, provides that for purposes of determining foreign base company income and insurance income under §953, these items do not include any item received by a CFC if the taxpayer establishes that such income was subject to an effective foreign tax rate greater than 90% of the maximum rate specified in §11. This does not apply to "downstream" oil related income. With regard to this rule, *solely for purposes of applying the look through principles to dividends paid by a CFC* (but not for purposes of interest, rents and royalties), income (*other than high withholding tax interest and dividends from a noncontrolled §902 corporation*) is not treated as separate category income if the requirements of §954(b)(4) are met with respect to such income.[45]

Note: The operation of §954(b)(4), without §904(d)(3)(E), would not automatically result in eliminating as items of separate limitation income such items as financial services or shipping income for separate limitation purposes. Its operation is limited to the elimination of those items to which it applies from foreign base company income for purposes of inclusion in income under §951(a)(1)(A). Under the Senate bill, the §954(b)(4) exclusion for separate limitation purposes would have applied only to passive income. The exclusion was expanded by the Conference Committee to conform the look through principles insofar as practicable to subpart F principles. The exception for high withholding tax interest seems obvious; its exclusion under §904(b)(4) principles would defeat the purpose of the separate limitation for this item which is easily manipulable. The exception for dividends from noncontrolled §902 corporations is based on the fact that such items are not, as such, foreign base company income, and exclusion is thus not called for under the subpart F conformity goal.[46] There is, however, a passage in the Conference Committee report that appears to require comment. There it is stated that if a controlled foreign corporation makes the §954(b)(4) election[47] with respect to high withholding tax interest or dividends from a 10- to 50% U.S. owned foreign corporation and the controlled foreign corporation qualifies for the subpart F *de minimis* exception for the year, the income remains high withholding tax interest or separate limitation dividend income (as the case may be) for look through purposes.[48]

This statement is to be contrasted with the other statement mentioned above that the *de minimis* rule functions as a *de minimis* rule for the separate limitations for high withholding tax interest and dividends from noncontrolled §902 corporations.

Example: X Corporation, a CFC, is wholly owned by U.S. corporation A. In 1987, X receives a dividend from M Corporation, a foreign corporation organized in another country, in which it has a 20% stock interest. The remainder of M's stock is owned by foreign persons. Since M is not a CFC, and since, under §902(b), X is deemed to have paid the foreign taxes paid by M attributable to the dividend, the dividend qualifies as separate limitation noncontrolled §902 corporation dividend income. As subpart F FPHC income, it appears to be includible under §951(a)(1)(A) in gross income of A. However, A establishes that the earnings from which the dividend was paid were subject to foreign taxes at an effective rate of more than 90% of the U.S. §11 rate. The dividend is, therefore, excluded from foreign base company PHC income under §954(b)(4).

Assume that X has small amounts of other subpart F income, and that the requirements of §954(b)(3)(A) are satisfied. X distributes a dividend to A. Is any portion of the dividend to be characterized as separate limitation noncontrolled §902 corporation dividend income? The Conference Committee report statement appears to mean that the general rule that the *de minimis* rule functions with respect to all separate limitation categories does not apply where the satisfaction of the rule's requirements is due to an election under §904(b)(4) with respect to high withholding interest or noncontrolled §902 corporation dividends.

Thus, the *de minimis* rule for look-through purposes must be applied by taking into account the other rule that the §954(b)(4) election does not operate with respect to these two categories of separate limitation income. In the example above, if the dividend income, when added to other items of foreign base company income (and gross insurance income) exceeds the lesser of 5% of gross income or $1,000,000 amounts, while the *de minimis* rule may apply for subpart F purposes generally, it does not apply for the §904(d)(3) look-through principles.

(3) Examples

These statutory provisions are illustrated by the examples provided in the Conference Committee report.[49]

Example (1): A wholly owned CFC has gross (and net) income of $100 of which $75 is shipping income and $25 is non-subpart F services income. The shipping income includes $10 of FPHC rental income which, under the rules explained above, is treated as shipping, and not passive, income. The more than 70% full, inclusion rule applies, and all $100 of the CFC's income is included in the U.S. shareholder's gross income for the year under subpart F. However, only $75 of the §951(a)(1)(A) inclusion is attributable to the shipping income, and under the look through rules, this is treated as separate limitation shipping income for §904 purposes. The remaining $25 is overall limitation income.

Example (2): The next year, the CFC has another $100 of gross income. Of this, $4 is portfolio interest, clearly passive income. Another $96 is manufacturing income. The *de minimis* rule applies. The CFC pays $10 in interest to the U.S. shareholder. This is overall limitation income, as are any future dividends paid out of that year's earnings and profits.

[45] §904(d)(2)(E).
[46] *See* Conf. Rep. at p. II-575.
[47] That an election must be made is implied by the words "if it is established by the taxpayer."
[48] Conf. Rep. at II-576.
[49] Conf. Rep. at II-576-77.

Example (3): Another year, the CFC earns $100 of which $50 is foreign base company shipping income, and $50 is a dividend from a corporation, incorporated in a different country, of which the CFC owns 45% of the stock and foreign persons own the remainder. No deductions are allocable to these items of income. While the dividend, at first glance, would appear to be passive income, it is recalled that passive income does not include any of the other four new categories of separate limitation income. (*i.e.*, high withholding tax, financial services, shipping, and noncontrolled §902 corporation dividends).[50] The items of income received by the CFC are taxed by the CFC's country at an effective rate of 40%. It can, thus, be established by the taxpayer that the effective foreign rate exceeds 90% of the U.S. statutory rate (assumed, here, to be 34%, the highest rate imposed under §11), and §954(b)(4) applies to exclude these items from subpart F income. The CFC pays out all of the $100 remaining after taxes as a dividend. Half of the dividend is attributable to shipping income and half to noncontrolled §902 corporation dividends. The latter half must be classified as noncontrolled §902 corporation dividend separate limitation income, since the §954(b)(4) exclusion rule does not apply for purposes of the look through principles to such separate limitation income. The other half of the dividend is overall limitation income.

10. Definitions; Regulations Authorized

Paragraph (4) of §904(d) provides definitions for "controlled foreign corporation" and "United States shareholder" for purposes of §904(d). A CFC has the same meaning given the term in §957 (more than 50% [51] of the voting power or value of the stock owned by U.S. persons) taking into account §953(c)(substituting "25% or more" for "more than 50%" in the §957 definition in the case of a "captive" insurance company — refer to Chapter 63, *infra*). U.S. shareholder has the same meaning given the term by §951(b)(ownership of 10% or more of the voting power of a foreign corporation).[52] Here §953(c) is also taken into account. Under this subsection, relating to "captive" insurance companies, a U.S, shareholder is a U.S. person who owns any stock of a foreign corporation.

Section 904(d)(5) authorizes regulations "as may be necessary or appropriate for the purposes of this subsection" including regulations:

For the application of the paragraph (3) look through rules and the loss recapture provisions of §904(f)(5) (discussed below) in the case of income paid or loans made through one or more entities or two or more chains of entities.

(i) Preventing the manipulation of the character of income to avoid the separate limitations rules, and

(ii) Providing for look-through rules applicable to interest, rents, and royalties paid by entities which would be CFC's if they were corporations.

11. The "Source Rule"

Section 954(b)(5) has been discussed above. It requires that each element of foreign base company income be reduced under regulations prescribed by the Secretary to take into account deductions (including taxes) properly allocable to such income. As was seen above, these regulations, Regs. §1.954-1(c), provide for allocations of expenses, taxes, and other deductions to the gross income in a manner similar to that set forth in Regs. §1.861-8.[53] The Senate version of the bill contained "stacking" rules, under which in determining the extent to which they should be treated as s separate limitation income, dividends, interest, rents and royalties received by the U.S. shareholder of a CFC would be allocated first to passive income, and then, in order, to other categories of separate limitation income. In lieu of this, there was adopted a general look-through allocation rule with respect to interest, rents, and royalties and an apportionment rule with respect to dividends, similar to the rules of §904(g) for determining the extent to which subpart F, §551 FPHC, and §1293 [54] inclusions and dividends and interest paid or accrued by a U.S. owned foreign corporation (50% or more stock ownership, by voting power or value, by U.S. persons) with U.S. source income are treated as U.S. sourced.

However, the look through rules adopted by the Conference Committee did not entirely deal with the problems the Senate bill was designed to resolve. Cross crediting of taxes on overall limitation income with the usually relatively light taxes on passive interest income could be achieved by a loan to the CFC by the parent or a related person to the parent followed by a reinvestment by the CFC of the loan proceeds, *i.e.*, a back-to-back loan. The interest payment made by the CFC could be allocated under Regs. §1.861-8 principles in accordance with the fair market values of the assets generating taxable income.[55] This could result, at least in part, in an allocation of the interest expense to income other than FPHC passive income. To counter this, §954(b)(5) is amended to add that except to the extent provided by regulations, any interest paid or accrued by a CFC to any U.S. shareholder or any CFC related [56] to such shareholder, shall be allocated first to FPHC income which is passive income of the CFC to the extent thereof. This rule, termed a "netting rule" by the Conference Committee [57] is to be applied in conjunction with the §904(g) maintenance of source rules, and adopts a similar rule contained in §904(d)(3) of prior law §904(d)(3) (relating

[50] §904(d)(2)(A)(iii)(I).

[51] The House bill would have required ownership of 50% or more; *Cf.* §904(g)(6) definition of U.S. owned corporation for purposes of the source rules and §954(d)(3) defining control for purposes of the definition of "related person."

[52] The Act did not add a value ownership provision to this definition as it did in the case of §957 and other amendments relating to control and relationship factors.

[53] Which are specifically made applicable to §954(b)(4); Regs. §1.861-8(f)(1)(v).

[54] As amended by §1235(f)(4) of the Act.

[55] Under §864, as amended by §1215 of the Act, allocations and apportionments of interest expenses are to be made on the basis of assets only, and not on the basis of gross income (as was permitted under the regulations in certain cases). *See* discussion in Chapter 61, *infra*.

[56] The Conference Committee Report, Conf. Rep. at II-580, states that the term "related" used in these provisions has the meaning given the term by §954(d)(3). *See* B, 7, *supra*.

[57] Conf. Rep. at II-578.

to the separate limitation for passive interest).[58] There are authorized regulations which may provide that the same rule applies to interest paid by the CFC to other persons.

Under this rule, the CFC cannot generate passive income for the purpose of taking advantage of the allocation principles described. Any interest paid by it to the U.S. shareholder (or another related CFC) must be netted against its subpart F FPHC income to the extent thereof both for subpart F and foreign tax credit limitation purposes.[59] The Committee report states that it is anticipated that this rule will be extended to U.S. controlled noncorporate payors and U.S. controlled 80/20 companies to the extent that look through treatment is provided to such entities by regulations.[60]

This netting rule is referred to in the Act as the "source rule." [61] As will be further explained in the analysis below, the look through rules are, essentially, technically similar to the source rules of §904(g) and the look through principles of §904(d)(3) as in effect prior to the Act. These principles were expanded in the Senate version of the look through separate limitation rules applying the stacking technique, as noted above. The amendment to §954(b)(5) also authorized regulations providing that the netting of interest may also apply to interest paid or accrued to persons other than a U.S. shareholder or a related person to such shareholder. The Conference Committee report states that it decided not to expand the authorized scope of these regulations to require netting in the case of rent and royalty payments (which would more closely follow the Senate bill) until further experience with the new separate limitation rules indicates a need for such rules.

12. Effective Dates

The above described amendments to §904(d) apply to taxable years beginning after December 31, 1986.[62]

Transitional rules are provided by subsection (e) of Act §1201 relating to the application of the separate limitation provisions for high withholding interest. They are not to apply to interest received or accrued by any taxpayer during any taxable year beginning after December 31, 1986, and before January 1, 1990, on any "pre-1990 qualified loan." Also, they do not apply to the "phase-out percentage" of such interest after December 31, 1989 on any "post-1989 qualified loan."

Phase-out percentages are tabulated for the years 1990 through 1994 (a 5 year period) as follows: 80, 60, 40, 20 and 0.

A "pre-1990 qualified loan" is a qualified loan outstanding during any year before 1990 to the extent that any foreign taxes that would be creditable (disregarding §904) with respect all such loans do not exceed the "applicable credit limit" for such taxable year. This limit is equal to 110% of the "base credit amount" times the "applicable interest rate adjustment" for pre-1990 loans. For post-1989 loans a post-1989 interest rate adjustment is applied. The base credit amount is the principal amount of qualified loans held by the taxpayer on November 16, 1985 multiplied by the product of: (1) the interest rate applicable on such loan on that date and the foreign withholding tax rate applicable to interest payable on the loan on that date.

The "interest rate adjustment" is the ratio of the weighted average 6 month LIBOR for the taxable year to LIBOR on November 15, 1985 (8.25%).[63] For post-1989 loans, it is the LIBOR on the last day of the taxpayer's first taxable year beginning after December 31, 1988, to LIBOR on November 15, 1985.

A "qualified loan" is a loan made to any of 23 enumerated developing countries or any resident thereof for use in such country.

It is finally provided that no benefit is allowable under these transitional rules for any withholding tax imposed on qualified loan interest to the extent the rate exceeds the withholding tax applicable to interest on such loan on November 15, 1985.

A special transitional rule is provided for an unnamed Minnesota corporation, the provisions of which are not of sufficient general interest for inclusion herein.

C. Detailed Analysis

As the committee reports indicate, both tax related and nontax related reasons impelled Congress to expand and refine the provisions of §904(d). One of these was the general lowering of U.S. tax rates which will exert pressure on tax planners to avoid any resulting excess credit positions with little possibility of ultimate absorption by way of carryover. One of the most often used avoidance devices has been the generation of lightly taxed foreign source income to increase the value of the §904 limitation fraction and achieve the cross crediting effect the separate limitations provisions are intended to minimize. Another professed goal of these provisions was to eliminate existing incentives to the shifting of certain types of investment to foreign jurisdictions. This is an application of the well-known principle of tax neutrality; U.S. tax laws should not make it more advantageous for a given investment or business operation to be made or carried on outside of the U.S. The determining factors should be nontax related insofar as practicable. These provisions must, therefore, be scrutinized to determine whether they operate merely to frustrate tax motivated transactions or pose substantial burdens on international operations of U.S. persons.

1. The Expansion of the Separate Limitations Categories

a. Passive Income: Exceptions

The most sweeping of the five new categories of separate limitation income is passive income, income, generally, of a type which, if earned by a CFC, will be included in income of its U.S. shareholders under §951 as foreign base company personal holding company income or under §551 as foreign personal holding company income. As the term implies, it is income which can usually be sourced by the

[58] *See* General Explanation of the Revenue Provisions of DEFRA of 1984, Joint Committee on Taxation, December 31, 1984 at 355.
[59] Conf. Rep. at. p. II-578.
[60] *Id.*
[61] Heading of Act §1201(c).
[62] Act §1201(e).
[63] *See* Conf. Rep. at II-588.

controlling interests in whatever foreign jurisdiction is most favorable from a tax viewpoint and is usually lightly taxed. The reasons for requiring a separate limitation for such income are basically the same as those which gave rise to the separate limitation for passive interest under §904(a)(1)(A) under prior law. Its principal component, subpart F FPHC, is a category of income substantially expanded by amendments to §954(c).[64] Also included is FPHC income as defined under§551 and inclusions under new §1293 (Added by Act §1235(a)).[65]

There are two groups of income excepted from the passive income category even though some portion of such income would otherwise be classified as passive. First, there are the other four categories of separate limitation income, namely, high withholding tax interest, financial services income, shipping income, and dividends from noncontrolled §902 corporations, each of which was discussed in B, *supra*. These exceptions may be termed the (2)(A)(iii)(I) exceptions. The second group consists of export financing interest, high taxed income and foreign oil and gas extraction income.

Some points that merit emphasis:

(1) Export Financing Interest

It was already noted that export financing interest is excluded from both the high withholding tax interest and financial services separate categories. Such interest includes not only interest received by the person whose products are exported abroad but persons related to such person. This exception has as its sole purpose the fostering of export trade, and, because it is excluded from high withholding tax interest and will generally be included in the overall basket, it offers a window for advantageous cross crediting to those in a position to take advantage of the exception.

(2) High-Taxed Income

The high-taxed income exception, applicable only to passive income, may cause problems since for such income to qualify, the taxpayer must establish the effective foreign rate. The "kick-out" operates only at the U.S. taxpayer level. In other words, the high tax refers to a foreign tax for which the recipient of the income is entitled to a credit against U.S. taxes. Determining the effective foreign rate will necessitate an allocation of the recipient's deductions in the manner prescribed by Regs. §1.861-8.[66] The Conference Committee agreement does not mandate separate application of the kick-out to individual items of income which the IRS determines may be grouped without diminishing its intended effect, *i.e.*, unduly permitting cross crediting of the high taxes and the relatively low taxes on passive income, taking administrative convenience into account.[67] However, the report indicates that passive income items from one CFC subject to high tax on a grouping basis may not be grouped with such income items of another CFC not subject to high tax, and that, generally, dividends paid by a CFC, which will usually not be passive income, are not to be grouped with any other items. Passive income items of a branch may also be grouped in appropriate circumstances if the IRS so rules, and it is suggested that this treatment might be based on treating as a branch a "qualified business unit," a term used in the provisions relating to foreign currency exchange gain or loss.[68] High-taxed foreign income received by a CFC will usually qualify for exclusion from subpart F FPHC under §954(b)(4) if the taxpayer so elects. If this is done, the kick-out will apply only at the time credits are computed with respect to the repatriation of the income as a dividend.

The report also notes that regulations are to prescribe rules for applying the high-tax kick-out with respect to distributions of previously taxed subpart F income where such distributions are subject to a high foreign tax. The Committee notes that adjustments to tax liability with respect to such distributions will normally be made in the year of distribution and not the year of inclusion under subpart F, referring to the special rules of §960. In any event, with respect to *all* separate limitations, it is intended that any foreign taxes imposed on such distributions, to the extent creditable, be assigned to the same limitation basket or baskets as the prior subpart F inclusions to which they relate.

The high-tax kick-out introduces a very substantial degree of complexity into these provisions. To determine whether a given item of income was subject to a foreign tax at an effective rate higher than the highest U.S. statutory rate, two steps are necessary. First, the foreign tax applicable to that item must be determined. This may be a very difficult task. It will often require an analysis of the foreign tax laws to ascertain (1) the amount of such income included in the foreign tax base net of deductions, exemptions, etc. allowable under foreign tax laws, and (2) where the structure of the foreign tax system provides for different rates on different types of income, it may not always be evident how much of the total foreign tax is attributable to a particular item of passive income. Once a determination has been made, as to the quantum of foreign tax imposed on the item, the U.S. taxpayer must allocate deductions to the item under Regs. §1.861-8. Only when the amount of the item net of such allocation has been determined can the effective rate of foreign tax be computed. This process may involve very burdensome recordkeeping, to say nothing of the task of analyzing foreign tax laws. It is perhaps for these reasons that the Senate bill made no provision for the kick-out, replacing it with authority to promulgate regulations to prevent abusive manipulation of the character of income to avoid the consequences of the separate limitations provisions.

b. High Withholding Tax Interest

As is noted in the Finance Committee report [69] it was well known in the financial community that a greater

[64] *See*, Chapter 63, *infra*.

[65] *See* Chapter 64, *infra*, relating to gains from the disposition of stock in a foreign passive investment company, FPIC. It is to be noted that under §951(d), if an item is both foreign base company PHC income and §551 FPHC income, it is treated as the former. Also, under §551(g), as added by Act §1235(c), if income is includible in income under §551(a) and new §1293, it is treated as included under §551(a). Thus, in applying the look through rules, apparently both §551 FPHC income and inclusions under §1293 are treated as inclusions under subpart F.

[66] *See* Conf. Rep. at II-568-9.

[67] *Id.*

[68] *See* Chapter 60, *infra*.

[69] S. Rep. at p. 350.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

after-tax yield could be realized from loans to certain developing countries imposing high gross withholding taxes on interest than from similar loans made elsewhere due to the fact that (1) because of this impost, borrowers would have to pay a higher rate of interest for lenders to realize an after-tax amount equal to market rates, and (2) taking into account the lender's cost of the money lent, the effective rate of tax on net interest income in such a case would generally be greater than the U.S. rate, generating foreign tax credits available for use against U.S. taxes imposed on other lightly taxed foreign income. As noted above, separate category treatment for such income generally overrides other separate categories [70] but recipients of export financing interest may include all of such interest in the overall category whether or not it is subject to high withholding tax. High withholding tax is defined as a tax on gross interest of 5% or more.[71] This, of course, leaves open the possibility of arranging for rates of 4.9% which, when net interest is taken into account, could easily exceed the new 34% corporate rate. It is to be noted also that the provision applies for look through purposes and not, as in the case of high taxed income, only at the U.S. level. How this operates was illustrated in the discussion of the statutory provisions in B, *supra*.

It was noted in B, *supra,* that under §904(d)(2)(E)(ii), if a foreign corporation is a noncontrolled §902 corporation with respect to the taxpayer, taxes on high withholding interest, to the extent they exceed 5% are not treated as foreign taxes for §902 deemed paid purposes. The Conference Committee report [II-587] provides an example of how such interest received by a noncontrolled §902 corporation is treated.

> *Example:* Assume that an offshore bank has a 40% U.S. owner and a 60% foreign owner. It earns $2,000 of gross interest income and incurs $1,700 of interest expense. On thousand dollars of the interest income is subject to a 10% gross withholding tax and is, therefore, high withholding tax interest.
>
> The foreign corporation incurs no other expenses and earns no other income. Its earnings and profits are $200 ($2,000 gross interest income less $1,700 interest expense less $100 withholding tax). It pays the full $200 out as dividends. Its U.S. shareholder receives $80 (40%) of the $200. The provision treats as noncreditable that portion of the 10% withholding tax exceeding 5%. Therefore, $50 (5% of $1,000) of the $100 withholding tax is noncreditable. The U.S. shareholder's deemed-paid credit with respect to the $80 dividend it receives is therefore reduced from $40 (40% of $100) to $20 (40% of $50).[72]

The transitional rule outlined in B, is somewhat complex. It differs from a similar rule contained in the Senate bill. Since the rule applies to interest on loans to less developed countries and their residents, it, in effect, covers almost all high withholding interest situations. The provision is phased out over a five years period beginning with the first taxable year after 1989 on post-1989 (new) qualified loans. What is a new loan is to be determined applying the provisions of §1001.[73] As to pre-1990 loans, exemption from the high withholding tax interest limitation is determined as follows: First, the "base credit amount" is determined. To obtain this, the principal amount of all qualified (LDC) loans in existence on November 16, 1985, is determined. Assume, for example, that this is $5,000,000. This amount is multiplied by the product of (1) the interest rate applicable to such loans on November 16, 1985, and (2) the withholding tax rate applicable to such interest.[74] Apparently this is to be done with each such loan. Thus, if there is one loan with a principal amount of $500,000, an interest rate of 11% per annum and a withholding rate of 7% on gross interest, the base credit amount is $3,850. The applicable credit limit is then determined by multiplying the latter figure by the interest rate adjustment. Assume that the year is 1988 and the weighted average LIBOR rate is 9.5% for that year. The same LIBOR rate on November 15, 1985, was, as was stated above, 8.25%. The ratio is 1.25. This is multiplied by $4,235 (110% of $3,850) to obtain a product of $5,294. The is the "applicable credit limit." [75] This process is applied to each loan outstanding during 1988 not to exceed the November 16, 1985, high-water mark.

The result is the total amount of foreign tax credit allowable on all high withholding interest qualified loans for the year. A similar process is applied to post-1989 loans subject to the five year phase out. Interest not treated as high withholding tax interest by reason of this transitional rule is passive income (subject to the high-tax kick-out) unless it is received by an entity predominantly engaged in the active conduct of a banking, insurance, financing or similar business, in which case it is financial services category income.[76] One may assume that most of the beneficiaries of this transitional rule will qualify as predominantly engaged in banking.

Note: The transitional rule provisions worked out in committee with representatives of lenders with substantial amounts of such loans seems technically flawed. The intended beneficiaries of the seemingly very generous relief measure are probably mostly large banks and financial institutions who are experiencing well publicized problems with these LDC loans. Since the transitional rule is not of general interest, no attempt will be made here to discuss its details.

Under the transitional rule, no relief is provided with respect to any foreign tax imposed on interest payable with respect to qualified loans to the extent the tax rate exceeds the withholding rate applicable on November 16, 1985.[77]

[70] The Conference Committee Report states that the separate high withholding interest limitation applies to *all* interest recipients (subject to the export exception)." But the wording of the statute does not appear to make it applicable to shipping income.

[71] §904(d)(2)(B)(i)(II).

[72] Note that under this shorthand computation, the noncreditable tax is treated as an allocable expense. On other $250 net interest income, the bank is deemed to pay a tax of $50, resulting in an effective rate of 20%. The $80 dividend grossed up to $100 ($80 ÷ .8) is multiplied by the 20% effective foreign rate to obtain the credit.

[73] Conf. Rep. at II-588.

[74] Act §1202(e)(2)(F)(ii).

[75] Act §1202(e)(2)(F)(i).

[76] Conf. Rep. at II-589.

[77] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

c. Financial Services Income

Income includible in this category as derived in the active conduct of a banking, financing, or similar business would, normally, include income attributable to any of the activities listed in Regs. §1.954-2(d)(2)(ii)(A) through (G).[78] The Conference Committee adds to this list a number of other types of what it considers to be financial service related items which would qualify.[79] Financial services also includes insurance income consisting of premium and other insurance income. It includes such income of offshore captive insurance companies whose U.S. owners are taxed currently under 1986 Act amendments to §957.[80]

Where an entity is predominantly engaged in such activities (banking, insurance, financing, etc.) its passive and shipping income is swept into the financial services basket. It is intended that a person so engaged be able to cross credit taxes imposed on all of its various types of income related to the predominant banking, etc. business operations. But, where the banking or financing is merely a sideline (perhaps created in an attempt to obtain the cross crediting privilege) passive and shipping income retain their separate limitation status. Regulations will prescribe rules for determining the circumstances under which an entity will be treated as predominantly engaged. In many cases, this will be clear at a glance. In others, the determination may well give rise to considerable controversy.

The Conference Committee Report relates that the conferees intend that the predominantly engaged test will be met if either the U.S. income recipient or the related payor of the foreign income independently satisfies it.[81] Thus, income of a U.S. shareholder in a foreign bank treated as predominantly engaged will, whether included under subpart F or received as a dividend distribution, be treated under the look through rules as all financial services separate limitation income. The same holds true where the U.S. shareholder is a bank. It follows that income which would qualify as passive or shipping income under the look through rules will be treated as financial services income. Such financial services income is exempt from the high-tax kick-out (but not the high withholding tax exclusion).

Finally, the Committee Report notes that income from such activities as equipment leasing, precious metals and commodity trading, and virtually all financing activity, where such activities are integrally related to the active conduct of banking, etc., will be included in financial services income where the predominantly engaged qualification is met. On the other hand, income from activities having no relationship to financial services will not be so characterized solely by reason of the recipient's meeting the predominantly engaged qualification. Examples of such unrelated income are income from data processing services, the sale of goods, or the providing of nonfinancial services.

2. The Look-Through Rules

a. Conformity With Subpart F Rules

In drafting the look through rules of §904(d)(3) it was intended by Congress, as already noted, to mesh the subpart F rules and the separate limitation rules insofar as possible. The new categories of separate limitation income are all items that would normally be included in foreign base company income as redefined by 1986 Act amendments. Where received by a CFC, these items are automatically included in the U.S. shareholder's gross income, after allocation of the CFC's expenses under §954(b)(5), and fall into their separate limitation categories as if received directly by the shareholder without the intermediation of the CFC. Under §904(d)(3)(B), each item of such net foreign base company income so included is attributable to the foreign base company income of the CFC. Thus, if the CFC has $19,000 of net interest from an unrelated corporation qualifying as FPHC income under §954(c), includible, as such, in the U.S. shareholder's gross income under §951(a), and the U.S. shareholder has no deductions properly allocable to such income, the $19,000 is passive income subject to the separate limitation of §904(d)(a)(1)(A), provided it is not subject to the high-tax kick-out.

Note: If the income is high taxed income in the hands of the CFC, an election can be made under §954(b)(4) to exclude such income from inclusion under §951. In such a case, for purposes of the dividend look through rule of §904(d)(3)(D), the income is not treated as income in a separate limitation category.[82] Thus, when it is subsequently distributed as a dividend, to the extent the dividend is deemed, under the apportionment rule of §904(d)(3)(D), to have been made from such income, it is overall limitation income in the hands of the U.S. shareholder.[83]

Since the income is category (A) passive income, the U.S. shareholder must compute separately the §904(a) limitation with respect to any foreign tax paid on this income. Assume that under §960 there is deemed paid a foreign tax of $5,000 on the $19,000, and that the same U.S. shareholder receives another $20,000 in interest from a loan to an unrelated foreign entity subject to a withholding tax of $800. The subpart F inclusion grossed up for the deemed paid tax is $24,000. The $20,000 in other interest is added to the $24,000 in computing the separate limitation for passive interest. Assume that there was no other foreign income, that the U.S. shareholder's total taxable income was $3,000,000 and that its U.S. tax was $680,000. The limitation applicable to the passive income is $9,973, amply sufficient to absorb the $5,800 in foreign tax, with an excess credit available for carryover (but only to offset U.S. tax on future passive income) of $4,173. Assume, next, that the U.S. entity's $3,000,000 in taxable income included $1,200,000 in dividends from foreign corporations, both CFC's and noncontrolled §902 corporations engaged in manufacturing, none of which is passive income under the look through rules. Foreign taxes deemed paid on such income total $500,000. Of the U.S, corporation's deductions, $50,000 is allocable to this dividend income under the §861 regulations. The §904(a) limitation with respect to the credits under §902 is $260,667. None of the excess credit computed under the passive income separate limitation may be applied to offset the residual U.S. tax on the dividend income. It must be carried forward for application

[78] Conf. Rep. at II-570.
[79] *Id.*
[80] *See* discussion in Chapter 61, *infra*.
[81] Conf. Rep. at II-571.
[82] §904(d)(3)(E).
[83] *See* Conf. Rep. at II-575.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

against U.S. taxes on passive income in future years, to the extent the §904(a) limitation permits.

The rule that passive, financial services or shipping income of a CFC which is excluded from subpart F income by §954(b)(4) because such income bears foreign taxes greater than 90% of the U.S. rate, is automatically treated as overall limitation income has been discussed in the Note above. However, under §904(d)(3)(E), this rule does not apply to either high withholding tax income or dividends from a noncontrolled §902 corporation. In the latter case, the nonapplication is explained by the fact that such noncontrolled corporation income bears no relation to subpart F income categories. Also, as has been explained, where high withholding tax or noncontrolled §902 corporation dividend income is excluded from foreign base company income under the provisions of §954(b)(4) and, for the same taxable year the CFC is deemed, by virtue of the *de minimis* provisions of §954(b)(3), not to have any foreign base company income, the normal rule that distributions of earnings and profits for a CFC year to which the *de minimis* rule of §954(b)(3)(A) applies are treated as overall limitation income is inoperative. Where high withholding tax interest or a noncontrolled §902 corporation dividend previously excluded under §904(b)(4) is repatriated by a dividend, such income retains its character for purposes of applying the apportionment rule of §904(d)(3)(D). Thus, if 50% of the CFC's earnings and profits from which the dividend is made consists of such previously excluded high witholding tax interest or noncontrolled §902 corporation dividends, 50% of the dividend will be classed as income in these separate limitation categories to the extent thereof.

The source of amounts included in a U.S. shareholder's income under §951(a)(1)(B),[84] with respect to the investment of earnings in U.S. property cannot be determined. The funds so invested could come from any one of the CFC's activities. Thus, notwithstanding the fact that a CFC could have only one income generating activity, such inclusions are treated for the look through rule purposes as dividends.

b. Dividends

The look through rule for dividends from a CFC is that a dividend is separate limitation income in the same proportion that the earnings and profits from which the dividend was paid were attributable to the various categories of separate limitation income. Such earnings and profits are broken down into their separate limitation income components, and each such component is divided by total earnings and profits to determine its percentage of the whole. The percentage obtained is then applied to the amount of the dividend. Where the dividend is made up in whole or in part of earnings and profits which were included in the shareholder's gross income under §951, and, for this reason, is excluded from income under §959(a), §959(d), as amended by the Act, provides that the distribution, to this extent, is treated as a distribution that is not a dividend but shall be applied to reduce the earnings and profits of the CFC. It is, therefore, not a dividend for look through purposes. As a result, in applying the look through rules to dividends distributed by the CFC, in allocating the dividend on a proportional basis to earnings and profits in each separate limitation category, the numerator or denominator (as the case may be) of the ratio is reduced by earnings and profits attributable to previously taxed subpart F income that has been distributed.

Where previously taxed subpart F income is distributed by the CFC, such distribution may itself attract a foreign tax. If so, the high tax kick out rule may apply. Regulations are to be issued dealing with this situation.[85] But any adjustment to tax liability will be made only for the year of distribution.[86] Further, where a foreign tax is imposed on distributions of previously taxed subpart F income, the Conference conferees intend that any such taxes be assigned to the separate limitation baskets in which such previously taxed income was included.[87] This may well pose some tracing difficulties unless an allocation method is provided by the regulations.

The Conference Report also makes it clear that gain from the sale of stock in a foreign investment company treated as ordinary income under §1246 is not a dividend for look through purposes (as it was under the House and Senate bills) but is treated as passive income. However, gains taxed under §1248 are treated as dividends.[88] Dividends include, of course, the §78 gross up, but, as already explained, gross up attributable to a subpart F inclusion is not treated as a dividend but as part of the subpart F inclusion for look through purposes.

c. Interest, Rents and Royalties

Interest, rents, and royalties are subject to an allocation rule. For purposes of determining their separate limitation category status in the hands of the U.S. shareholder recipient, these amounts are treated as expenses of the CFC allocable to the CFC's gross income under the rules of Regs. §1.861-8. Thus a payment of rent, for example, is treated as separate limitation income to the extent it is allocable, under the §861 rules, to a category of separate limitation income of the distributing CFC. This general rule, however, is subject to the income netting rule of §904(c), discussed below, which overrides the normal allocation rules. Thus, where the CFC pays or accrues interest to a U.S. shareholder, this interest is allocated first to *any FPHC income of the CFC which is passive income* and is, therefore, passive income, to the extent it is so allocable, in the hands of the recipient. Following this, if interest is allocable to manufacturing or some other overall limitation category, it is overall limitation income in the recipient's hands.[89]

[84] Technically, this is not subpart F income which is defined by §952. The amount of the inclusion is determined under §956.

[85] Conf. Rep. at II-569.

[86] *Id.*

[87] *Id.*

[88] Conf. Rep. at II-581.

[89] In the case of interest, under the fundability theory, there will not be a case in which it is definitely unrelated to any of the CFC's income. Under the §861 regulations, it will be treated as definitely related to all of the payor's income. However, as noted above, under §864, as amended by the Act, interest is allocated and apportioned on the basis of the payor's assets rather than on the basis of gross income. §864(e)(2).

d. The Source or "Netting" Rule

It should be understood that this netting rule, added to §954(b)(5), which is part of the subpart F provisions, applies both for foreign tax credit purposes and for subpart F purposes. This may be extended by regulations to interest payments of the CFC to other unrelated persons.[90] In addition, it may be extended to noncorporate U.S. owned payors and 80/20 corporations to the extent that look through rules are applied to them by regulations.[91]

Where the CFC has subpart F FPHC income and pays interest to a U.S. shareholder, the reduction under §954(b)(5) is applied by according the interest priority in the allocation process, as if it were determined that the interest, irrespective of the value of the assets generating other types of income, was definitely related to the generation of all passive income to the extent thereof. Rents and royalties are allocated to the CFC's income to which they definitely relate and then are ratably apportioned among other types of income unless there is definitely no relation to such income.[92] Usually, therefore, such payments will be treated as overall limitation income in the U.S. shareholder's hands, since rents and royalties usually relate to income from carrying on some form of active business. This, however, may not always be the case. Thus, if the royalties are paid with respect to intangibles which the CFC had, in turn, sublicensed, the royalty payments would be allocated to the licensing income and would be treated as passive income in the hands of the U.S. shareholder recipient. The §861 regulations, therefore, seem to prevent any separate limitation avoidance by way of back-to-back rental or royalty arrangements. For this reason, the Committee Report notes that it was decided that the extension of regulatory authority to prescribe netting rules for rent and royalty payments was not necessary. However, it was added that existing regulation could be amended to remove any doubt in this respect if needed.[93]

The Committee Report notes that the interest netting rule is to be applied also for purposes of the rule of §904(g)(3) maintaining the source of U.S. source income. Thus, interest paid to a U.S. shareholder by a CFC with U.S. source passive income will, for purposes of determining its source, first be allocated to such passive income, rather than, as under prior law, following the §861 regulations, on the basis of the value of the assets generating the CFC's income.[94] This application of the netting rule to the source maintenance rule will, in addition to the separate limitations amendments, further adversely affect the foreign tax credit position of many U.S. taxpayers.

e. Miscellaneous Amendments

It should be noted that §1201(b) of the 1986 Act which repealed §904(d)(2) and (3) effective for years after 1986, amended these provisions relating to the separate limitation for passive interest effective for taxable years prior to 1987. The *de minimis* rule of §904(d)(3)(C), applicable where a designated payor corporation's passive interest is less than 10% of its earnings and profits, is amended to provide that this does not apply to amounts includible under §551 or §951. Also, §904(d)(2), defining passive interest, is amended to add that interest (after application of (d)(3)) received from a designated payor by a person owning less than 10% of the voting stock is treated as passive interest only to the extent it would be so treated if the look-through principle did not apply.

[90] Conf. Rep. at II-578.
[91] *Id.*
[92] *See* Regs. §1.954-1(c).
[93] Conf. Rep. at II-579.
[94] *Id.*

III. Amendments to the Deemed Paid Credit

A. Background and Legislative History

Section 902, as in effect prior to the 1986 amendments, provided that, for purposes of §901, where a domestic corporation receives a dividend from a foreign corporation (whether or not a CFC) and, at the time the dividend was received, the domestic corporation owns 10% or more of the voting stock of such corporation, it is deemed to have paid the foreign taxes imposed on the distributing corporation with respect to the earnings and profits out of which the dividend was paid. Thus, if in Year 1, the foreign corporation had total taxable income of $1,000,000, computed under U.S. tax accounting principles, and paid total foreign income, war profits or excess profits taxes on such income of $360,000 (an effective foreign rate of 36%) and, if in Year 4, the corporation distributed as a dividend to a domestic corporation owning 100% of the foreign corporation's stock at the time of the distribution, $200,000 of its accumulated (post-tax) earnings and profits attributable to Year 1, the dividend recipient was deemed to have paid a portion of the $360,000 in Year 1 foreign taxes imposed on the distributor. The amount was determined by multiplying the total foreign taxes imposed on the accumulated profits from which the dividend was paid (that is, the pre-tax taxable income for the year) by a fraction, the numerator of which was the amount of the dividend and the denominator of which was the accumulated profits in excess of the foreign tax. Under the facts assumed above, the credit is computed as follows:

$$\$360{,}000 \text{ (foreign tax)} \times \$200{,}000/\$640{,}000 \text{ (post-tax Year 1 income)}$$

In the example, the foreign tax deemed paid is equal to $112,500. This is creditable, subject to the §904 limitation, but the taxpayer must include in income the grossed up dividend, that is the amount of the distribution plus the foreign tax deemed paid. Where the dividend is attributable to the earnings and profits of more than one year, the above formula must be applied to each such year. The dividend must, therefore, be traced to post-tax earnings and profits. However, a dividend paid within the first 60 days of the distributor's taxable year is deemed made from the previous year's (or years') income.

Another way to determine the deemed paid tax is simply to determine the effective foreign rate, here 34%, and apply that to the dividend. Thus, grossing up the dividend to reflect pre-tax taxable income ($200,000 ÷ .64) yields $312,500. This equals the pre-tax earnings to which the dividend is attributable. The taxes deemed paid are

34% of this amount, $112,500. Then, under §78, the grossed up dividend is included in the shareholder's gross income, and the $112,500 credit applied, subject to the limitation of §904(a), to offset the shareholder's U.S. taxes on its U.S. taxable income for the year. A similar gross up under §78 applies in the case of an inclusion under §951.[95]

Under §960, a similar rule is adopted with respect to the foreign taxes paid by a CFC on that portion of its earnings and profits included in the gross income of the U.S. shareholder under §951. The amount of the credit is the tax paid by the CFC times the amount of the §951 inclusion divided by the CFC's earnings and profits (after-tax income) for the year. In this case, however, since such income is included currently under §951, there is no need to trace the provenance of the inclusion.

Under §902(b)(1) and (2), the deemed paid rules are extended to taxes paid by first and second tier subsidiaries of the 10% or more owned foreign corporation. That is, where the first foreign corporation receives a dividend from a second tier foreign corporation in which it has a 10% stock interest at the time of the distribution, such first corporation is deemed to have paid the foreign taxes imposed on the second tier corporation with respect to the accumulated profits from which the dividend was paid. In the same manner, taxes paid by a foreign corporation in which the second tier corporation has a 10% stock interest are deemed paid by the latter upon receipt of dividends from such third tier corporation, but the deemed paid rule does not extend to taxes paid by fourth and lower tier entities. The deemed paid rules apply to the lower tier foreign corporations, however, only if a 5% stock ownership condition, set forth in §902(b)(3)(A) and (B), is met, as will be explained below.

In the case of inclusions under §951, where a second or lower tier corporation is a CFC (applying the attribution rules of §958), the income is included directly in the gross income of the U.S. shareholder. A deemed paid credit is allowed in this case under §960 without dilution by passing through intermediate subsidiaries, but, as in the case of the §902 deemed paid rules, (a) no tax payments by a corporation lower than the third tier are taken into account, and (b) for tax paid by a second or third tier corporation to be treated as deemed paid by the domestic entity, the 5% stock ownership rule is applied.

This method presents two problems. First, the dividend must be traced to its source, the particular accumulated profits from which it was paid, for a credit to be allowed. Distributions were deemed to be made first out of the most recently accumulated profits, but, under a special rule, distributions made during the first 60 days of a taxable year were treated as made from the prior year's accumulated profits. This rule applied also for purposes of §960. The tracing presented a number of difficulties, especially where the 10% stockholder was a minority shareholder without easy access to the distributor's books and records, or where dividends were infrequent and tracing was required to earnings for several years prior to the year of distribution. Aside from these difficulties, there was a major technical problem. In Rev. Rul. 74-550, 1974-2 C.B. 209, the Service ruled that in determining "accumulated profits in excess of the foreign tax," where the foreign corporation sustained a net operating loss (computed under U.S. tax rules), there could be no "accumulated profits" for that year. Further, such loss must be carried back to reduce accumulated profits for all previous years to the extent of the loss.[96] The result was in many instances to deny or substantially reduce the credit allowable for foreign taxes paid on what was treated as taxable income under the applicable foreign tax law but was treated as zero or a reduced amount of income for U.S. tax purposes.

These rules produced another difficult to justify result. For various reasons, effective foreign tax rates can change from year to year. It was seen that the amount of the credit allowable with respect to distributions from the earnings and profits of a given taxable year of the foreign corporation depends on the effective foreign rate for that year. If the foreign corporation has pre-tax earnings of 100 for each of two years, and the effective foreign tax rate on the first year is 20% and that for the second is 50%, leaving it with a total of 130 in after-tax earnings, a distribution of 50 made at the end of the second year will be treated as made from the earnings of the high tax year with a correspondingly greater credit than if treated as distributed from the low tax year's earnings after tax. U.S. shareholders with interests in two or more foreign corporations could maximize their credit position by causing high tax year profits to be distributed at such a time as to obtain the highest credit which could then be averaged with low tax year distributions of some other corporation, a planning device referred to as the "rhythm method." The tracing of dividends to discrete taxable years under these rules was viewed by Congress as anomalous since in the case of dividends from CFC's they produced tax credit results sometimes dramatically different from those which would obtain were the foreign business operations giving rise to the dividends conducted directly or through a foreign branch.

B. Overview

1. Pooling of Post-1986 Earnings and Profits and Foreign Taxes

The problems and incongruous results under prior law discussed above were eliminated by the pooling of all post-1986 earnings and profits of the foreign corporation distributing the dividend and by the corresponding pooling of all post-1986 creditable foreign taxes imposed on the accumulated profits of all post-1986 years.

Section 1202(a) of the 1986 Act amends §902(a) to provide that the amount of foreign taxes deemed paid by the 10% shareholder of a foreign corporation which makes a dividend distribution is determined by multiplying the foreign corporations post-1986 foreign taxes by a fraction; the numerator of which is the amount of the dividend (determined before any §78 gross up) and the denominator

[95] In determining the amount of earnings and profits for purposes of calculating the foreign taxes deemed paid under §960 with respect to an inclusion under §951, the regulations allow departures from U.S. tax accounting principles and U.S. accounting standards where not "material." Regs. §1.964-1(a).

[96] *See, e.g., Champion Int'l Corp. v. Comr.*, 81 T.C. 424 (1983) [cited in Sen. R. at 298].

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

of which is the aggregate of the foreign corporations undistributed post-1986 earnings. A similar rule is provided under amended §902(b)(1) and (2) for second and third tier foreign corporations as under prior law.

Amended §902(b) retains the prior law 5% stock interest requirement of §902(b)(3)(A) and (B)). Thus, the §902(b) deemed paid provisions apply only, in the case of a second tier corporation, if the percentage of stock owned by the domestic corporation in the first tier corporation multiplied by the percentage ownership of the first tier corporation in the second tier corporation equals at least 5%. This condition is met if, for example, the domestic corporation owns 25% of the first tier corporation's stock, and the latter owns a 20% interest in the second tier corporation.[97] A similar minimum stock ownership condition applies for application of the deemed paid rules to dividends distributed by a third tier corporation to the second tier corporation.[98]

Post-1986 earnings and profits means the amount of the earnings and profits of the foreign corporation (computed in accordance with §964 and new §986 (requiring that earnings and profits be computed in the functional currency of the foreign corporation and then translated into U.S. dollars)) accumulated in taxable years beginning after December 31, 1986—

> as of the close of the calendar year of the foreign corporation distributing the dividend, and
>
> without diminution by reason of dividends distributed during the year.[99]

Post-1986 foreign income taxes means the sum of—

> foreign income taxes imposed for the taxable year of the foreign corporation in which the dividend was distributed, and
>
> foreign income taxes for all prior post-1986 years to the extent they were not deemed paid with respect to post-1986 dividend distributions.[100]

Foreign taxes means income, war profits and excess profits taxes paid to any foreign country or U.S. possession.[101]

For purposes of determining other amounts of foreign taxes paid a by a foreign corporation, the term includes taxes deemed paid; a third tier corporation is not deemed to have paid any foreign taxes.[102]

2. Special Rule for Post-1986 Acquisitions

Where the 10% or more stock ownership of a foreign corporation necessary for the deemed paid credit rules to apply to subsequent dividends is acquired after December 31, 1986, the pooling of earnings and profits and foreign taxes is effected by taking into account only periods beginning on and after the first day of the first taxable year in which such ownership requirements are met.[103] This rule extends to the acquisition of stock by a first tier in a second tier, and by a second tier in a third tier foreign corporation.[104]

3. Accounting Periods

Where foreign taxes eligible for the credit are determined on the basis of an accounting period of less than one year, the term "year" as used in the §902 provisions means such accounting period.[105]

4. Distributions From Pre-1987 Earnings

The provisions of §902 as in effect prior to the amendments made by the 1986 Act are to apply to all dividends paid out of accumulated profits for any taxable year prior to the first taxable year taken into account in determining the post-1986 undistributed earnings of the distributor.[106]

Any dividend in a taxable year beginning after December 31, 1986, is to be treated as made out of post-1986 undistributed earnings to the extent thereof.

5. Conforming the §960 Credit

Section 960 is amended to conform it, generally, with the amendments made to §902. It is provided in amended §960(a)(1) that, except to the extent provided in regulations, the domestic corporation (in whose gross income earnings and profits of a CFC are included under §951(a)) shall be deemed to have paid a portion of such foreign corporation's post-1986 income taxes determined under §902 in the same manner as if the amount so included were a dividend paid by the foreign corporation (determined by applying §902(c) in accordance with §904(d)(3)(B)).

As seen above, §902(d)(3)(B) is the look through rule applicable to subpart F inclusions. The §902(c) rules outlined above are to be applied, therefore, to each item of separate limitation income.

6. Regulatory Authority

The Secretary is granted broad authority to issue regulations "necessary or appropriate to carry out the provisions of this section" including provisions "which provide for the separate application of this section and §960 to separate types of income or loss." What Congress intended to be provided in these regulations will be discussed below.

7. Effective Date

Act §1202(e) provides that the amendments made to §§902 and 960 (as well as technical amendments to §6038) apply to distributions by foreign corporations out of, and to inclusions under §951(a) attributable to earnings and profits for taxable years beginning after December 31, 1986.

C. Detailed Analysis

1. General Observations

The pooling of post-1986 earnings and profits and the related taxes offers a substantial simplification of the §902 taxes deemed paid rules. Pooling is triggered by the acquisi-

[97] As under prior law §902, the percentage of ownership is based on voting power alone, not value.
[98] §902(b)(3).
[99] §902(C)(1).
[100] 902(c)(2).
[101] §902(c)(4).
[102] *Id.*
[103] §902(c)(3)(A).
[104] §902(c)(3)(B).
[105] §902(c)(5).
[106] §902(c)(6).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tion by a U.S. shareholder of a 10% (or more) stock interest in a foreign corporation at any time during a taxable year of the corporation beginning after 1986. Pooling is effective beginning on the first day of such taxable year. Generally, all undistributed earnings and profits (including those for the year of the dividend or §951 inclusion undiminished by such dividend or inclusion) are added up and all foreign income taxes in excess of those deemed paid are totaled for the pooling period. Any dividend is treated as paid from the most recently added earnings and profits and the deemed paid credit is computed using as the effective foreign rate the average rate imposed during the pooling period. If for year 1 of the period, there were accumulated profits of 1000 on which a foreign tax of 300 was imposed, and if 700 was distributed and 233 of the 300 in tax was deemed paid by the distributee, there would remain for pooling purposes 300 in undistributed earnings and 67 of foreign taxes to be taken into account.

Both House and Senate bills included pooling provisions. The Senate bill provided for a 10-year moving pool, however. The Finance Committee Report [107] notes that if a dividend is paid by a lower tier to an upper tier foreign subsidiary, present law is to apply to determine the year in which the dividend is included in earnings and profits of the recipient. Thus a post-effective date dividend from a second tier to a first tier corporation increases the latter's earnings and profits for the year of the dividend. The recipient's deemed paid taxes are computed on the basis of the payor's most recent post-effective date pool of accumulated earnings and related taxes.[108]

It is made clear that pooling applies only for purposes of determining the deemed paid credit. The amount that can be included in income under §951 remains limited to the CFC's earnings and profits for the current year of inclusion. However, the amount of foreign tax deemed paid with respect to such inclusion is determined on the basis of the average rate for the pooled foreign taxes. Thus, the effect of pooling cannot be avoided by creating subpart F income.[109]

2. Regulations: The Separate Limitations Problem

The interaction between the pooling rules and the separate limitation rules is somewhat complex and will have to be addressed by regulations.

To apply the separate limitations provisions of §904(d), income (and losses) falling under each of the separate limitations categories will have to be pooled separately together with the related taxes. In the case of subpart F income, the §951 inclusion will be characterized on a prorata basis, that is, attributed to the underlying items of foreign base company income by category of separate limitation income. This does not apply to inclusions under §951(a)(1)(B)(investments in U.S. property) which are treated as dividends. The foreign tax imposed on each such category is determined on the basis of the accumulated pool of each such category of income and the related taxes. Under the anticipated regulatory rules, then, if there is a subpart F inclusion of passive income, and the average rate of foreign tax on the pooled passive income from which the distribution is deemed made is low, the foreign tax deemed paid with respect to this category of income should reflect that fact.

Obviously, the rules to be issued will involve a number of technical provisions to carry out the intent of both the pooling of income and taxes for purposes of the deemed paid credit and the purposes of the separate limitations provisions. At present, it is too early to speculate on their exact contents.

3. Repeal of the Subpart F "Chain Deficit Rule"

While discussed in detail in Chapter 23, *infra*, it is noted here that the repeal of the so-called "chain deficit rule" of former §952(d), and the amendment of the provisions of §952(c) relating to limitations of the application of CFC deficits to offset subpart F income of later years implement the separate limitations provisions. Under the provisions of §952(d), the so-called "chain deficit rule," if a CFC had a deficit in current earnings, another CFC in the same chain of ownership could apply the deficit (subject to certain limitations) to offset the subpart F income of another CFC. Further, under the rule (retained in the Act) of §952(c)(1) that a CFC's subpart F income cannot exceed its earnings and profits, current deficits in any income category could, under prior law, offset income in another, and a CFC's deficit in earnings and profits in a prior year could offset its subpart F income in a current year.

Act §1221(f) repealed §952(d). Further, it amended §952(c) to restrict the application of deficits of prior years to income of the current year. Such application is permitted only as to earnings from "qualified activities" and only to the extent of a "qualified deficit." Qualified activities are those giving rise to shipping income, oil and gas related income, insurance income of a qualified insurance company and FPHC income of a qualified financial institution. Qualified insurance companies and financial institutions must be "predominantly engaged" (*see*, discussion above relating to the separate limitation for financial services income) in insurance or the active conduct of banking, financing, etc, respectively. Under these new rules, separate limitation income of a CFC (which is usually subpart F income) is not eliminated by deficits of other CFC's or by deficits arising from previous years attributable to activities which do not generate the same category of separate limitation income. Note that, with the exception of qualified financial institutions, a deficit in an activity generating passive income in one year does not offet passive income in a later year. The Conference Report states that: "Preserving separate limitation income (otherwise eliminated by deficits) for foreign tax credit limitation purposes absent the indicated subpart F changes would necessitate more frequent application of the look through rule to dividends paid by controlled foreign corporations with passive income." [110]

[107] At 321.
[108] *Id.*
[109] *Id.*

[110] Conf. Rep. at II-578.

IV. Clarification of the Treatment of Foreign Losses

A. Background and Legislative History

As was noted above, in 1976 Congress enacted the provisions of §904(f), since amended, providing for the recapture of foreign losses. The recapture rule provides, generally, that where the taxpayer sustains an overall foreign loss in any taxable year, foreign source income recognized in a succeeding taxable year is recharacterized as U.S. source income for foreign tax credit purposes to the extent of such foreign loss previously allowed. However, the "recapture" is limited to 50% of the foreign income recognized in any taxable year until the loss account has been exhausted. The taxpayer can elect to apply a greater amount. The purpose of this general rule is to prevent what Congress perceived to be a double tax benefit in the case where the overall foreign loss reduced U.S. taxable income and where the foreign tax law did not provide for a deduction similar to the U.S. net operating loss carryover, the taxpayer obtained a benefit from the application of the foreign loss to reduce U.S. taxable income, and in the succeeding year was allowed a credit for taxes paid on the income (which, under U.S. tax principles, would be eliminated by the carryover) reducing U.S. tax a second time. Thus a credit was allowed for foreign taxes paid on what under U.S. tax law was zero taxable income. The change of source rule was enacted to cure this defect.

When separate limitation categories were enacted by §904(d), the question arose as to whether a net loss sustained in a separate limitation category (including the overall category) should be applied directly to offset U.S. taxable income, or whether it should be applied to reduce foreign income in other categories. The provisions of §904(f) as in effect prior to the 1986 amendments did not address this issue. However, §907(c)(4) provides that overall foreign extraction loss must first be applied against the taxpayer's other foreign income and then the taxpayer's U.S. taxable income. Such losses are subject to a separate recapture rule under which subsequent foreign extraction income is recharacterized as other foreign income to the extent of the extraction losses applied to such other income in the overall extraction loss year(s). Where an overall foreign loss is made up, in part, of an extraction loss, both recapture rules apply to subsequent years.[111] Congress was persuaded that in cases involving a U.S. taxpayer with net losses in one or more separate limitation categories, if separate basket losses could be used to offset directly U.S. taxable income without first being applied to other foreign income, substantial revenue loss could result, especially in cases where there was no subsequent income in that separate limitation loss category to which the change of source rule of §904(f) could be applied.[112]

B. Overview

1. Foreign Loss Allocation and Recharacterization Rules

Act §1203(a) amends §904(f) by adding new paragraph (5). Under the new provisions, the amount of the separate limitation losses for a taxable year must first be applied to reduce, pro rata, foreign income in other separate limitation categories, and only then may it be applied to reduce U.S. taxable income.[113] Where a separate limitation loss (assume for purposes of this explanation, a loss in category A) is allocated under the above rule to separate limitation income in another category (assume it was applied to income in categories B and C), and there is income in category A for a subsequent year, then such income, to the extent it does not exceed the separate limitation losses not previously recharacterized, is recharacterized as income from categories B and C in proportion to the previous reductions not previously taken into account.[114] The statute specifies that nothing in the recharacterization rules shall be construed as recharacterizing any tax.

2. U.S. Loss Allocation Rule

Subparagraph (D) of new §904(f)(5) contains rules applicable to U.S. source losses. Any U.S. source loss, to the extent it does not exceed the separate limitation incomes for the year, is to be allocated among, and reduce, such incomes on a proportionate basis. This rule is applied *after* the allocation of foreign separate limitation losses under §904(f)(5)(B), *supra*.

3. Definitions

Subparagraph (E) defines "income category," "separate limitation income," and "separate limitation loss." The latter term means, with respect to any separate limitation category, the loss from such category determined under the principles of §907(c)(4)(B) (relating to oil and gas extraction losses).

4. Effective Date

These amendments to §904(f)(5) apply to losses incurred in taxable years beginning after December 31, 1986.

C. Detailed Analysis

The Conference Committee report contains an example which seems adequately to explain the operation of the rules for the allocation and recharacterization of foreign losses:

> *Example:* A U.S. corporation earns $200 of U.S. source income and $20 of foreign income in the limitation category for FSC distributions. It also has a $20 overall limitation loss and a $5 shipping income category loss. Applying the proportionate allocation rule, $16 of the overall loss is applied to offset the $20 of FSC separate limitation income ($20 ÷ $25 × $20 = $16), and $4 of the shipping loss is so applied ($5 ÷ $25 × $20 = $4). The remaining $4 of the overall loss and $1 of the shipping loss are applied to reduce U.S. taxable income to $195. There is no foreign income for tax credit purposes. If the corporation earns sufficient overall limitation income in later years, then, after application of the general recapture rule of §904(f), $16 of such income is subject to recharacterization as

[111] *See* Sen. R. at 300-1.
[112] *Id.*
[113] §904(f)(5)(A) and (B).
[114] §904(f)(5)(C).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

FSC separate limitation income. The same applies to subsequent shipping limitation income.[115]

The Committee further clarifies application of the general foreign loss recapture rule in the light of the new separate limitations provisions. It is intended that foreign income earned in a year following an overall foreign loss year be recharacterized as U.S. source income only to the extent that the foreign income is of the same limitation category as the previous loss.[116] This may, admittedly, result in a much slower absorption of the foreign loss than under prior rules. For example, assume that a U.S. corporation incurs a $100 overall limitation loss and earns $300 of U.S. income in a taxable year. The full $100 loss is an overall foreign loss subject to recapture in a later year because U.S. income is offset by the full amount of the loss. In the following taxable year, the taxpayer earns $50 of overall limitation income, $150 of passive limitation income, and $250 of U.S. income. The conferees intend that the present-law 50% limitation (§904(f)(1)(B)) on the amount of foreign income that must be recharacterized as U.S. income in a taxable year be applied to the full amount of the corporation's foreign income, $200, as it would be under present law. Thus, up to $100 of foreign income can be recharacterized as U.S. income under the 50% limitation. However, the corporation has only $50 of income of the same limitation type (overall) as the prior year foreign loss. Only that $50 then is to be recharacterized as U.S. income under the overall foreign loss recapture rule. Thus, for foreign tax credit limitation purposes, the corporation has $150 of passive limitation income, $300 of U.S. income, and no overall limitation income for the taxable year. Up to $50 of overall limitation income earned in a subsequent year will be subject to recapture because only $50 of the $100 overall foreign loss incurred in the first taxable year has been recaptured.[117]

It was also thought necessary to clarify in the Conference Committee report the interaction between the new U.S. loss recharacterization rule of §904(f)(5)(D), outlined above, and the other rules relating to the allocation and recharacterization of foreign losses. The example provided in the report explains this clarification:

The taxpayer sustains a $100 U.S. source loss and a $50 overall category loss. It also has $600 of shipping category and $400 of passive income category foreign income. The foreign loss allocation rule is applied before the U.S. loss allocation rule. Thus, $30 of the overall loss is applied to reduce the shipping income and $20 is applied against passive income, reducing these amounts, respectively, to $570 and $380. Under the conference agreement, $60 of the $100 U.S, loss is applied to the shipping income and the remaining $40 to the passive income.

The following year, the taxpayer has a U.S. loss of $780. It also has $200 of overall limitation foreign income and $600 of shipping income. The U.S. loss allocation rule applies before the foreign loss allocation rule. Thus, $195 of the U.S. loss reduces the overall limitation income, and the remainder reduces the shipping income. For the year then, the taxpayer has no U.S. income, $5 of overall limitation income and $15 of shipping income before the application of the foreign loss allocation rule. Under the latter rule, $3 of the overall limitation income is recharacterized as shipping income, and $2 is recharacterized as passive income, since in the prior year $30 of shipping and $20 of passive income were eliminated by the $50 overall limitation loss.

Finally, in the current year, there is no U.S. income, $18 of shipping income and $2 of passive income. If overall limitation is earned in later years, up to $45 ($50 − $5) will be subject to the loss recharacterization rule.[118]

These "clarifications" will undoubtedly be set forth in regulations to be issued at a later date. The report states that these should provide for application of the foreign loss recharacterization rules to an entity that is a successor entity to the one that benefited from the previous application of the rule.

Other clarifications:

(1) The foreign loss allocation and recharacterization rules are to be applied on an affiliated group basis in the case of such a group which files a consolidated return.

(2) These rules also apply to net operating loss carryovers. The report posits a U.S. corporation operating mostly abroad with a $200 NOL attributable to activities that would generate overall limitation income, and which, the following year, has $180 of overall limitation income and $30 of passive income. In carrying the NOL forward, applying the foreign loss allocation rule, the carryover absorbs $180 of overall limitation income first (since the loss was sustained in that category) and the $20 remainder reduces the passive income. If $220 of overall limitation income is earned the following year, $20 of this is recharacterized as passive income.[119]

(3) As under the House and Senate versions of these rules, it is emphasized in the report that they in no way provide for a recharacterization of foreign taxes. Thus, where foreign income in basket A is recharacterized as income from basket B, the foreign taxes imposed on the income in the A basket are not to be treated as imposed on income in the B Basket in computing the limitations under §904(a).

(4) Finally, §952(c) (relating to limitations on the applications of deficits in determining subpart F income, discussed at II.C. above) was amended by adding paragraph (2) which provides that where a deficit in earnings and profits of a CFC is applied to offset the subpart F income of a later year, any excess of the earnings and profits for any subsequent taxable year over the subpart F income of the corporation for such year is to be recharacterized as subpart F income under rules similar to those of §904(f)(5). The amendments made to §952 are discussed in chapter 63, *infra*.

[115] Conf. Rep. at II-591.
[116] *Id.*
[117] Conf. Rep. at II-592.
[118] *Id.*
[119] Conf. Rep. at II-593.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

V. Other Foreign Tax Credit Related Provisions

A. Codification of Regs. §901-2(e)(3): Taxes Used as Subsidies

1. Statutory Provisions

Act §1204 adds a new subsection (i) to §901 (redesignating prior (i) as (j)) to provide that otherwise creditable foreign income taxes are not to be treated as taxes for credit purposes to the extent that the amount thereof is used (directly or indirectly) to provide a subsidy by any means to the taxpayer, a related person (within the meaning of §482) or any party to the transaction or to a related transaction.

The amendment applies to foreign taxes paid or accrued in taxable years beginning after December 31, 1986.

2. Committee Report Comments

The Conference Report [120] points out that the above codification of Regs. §1.901-2(e)(3) [121] is not intended to modify Regs. §1.901-2(f)(2)(i) which provides that a tax is treated as paid by the taxpayer for credit purposes even if another party to the transaction with the taxpayer agrees, as part of the transaction, to assume liability for the tax.

An example of such a subsidy situation is contained in the Finance Committee Report (page 325). Assume that a U.S. bank lends money to foreign development bank B which relends the money to residents of its country. B's country of residence imposes a withholding tax on the interest paid to the U.S. bank. Of such tax, half is credited by the tax authorities to an account of B which amount B is obligated to pay over to the resident borrowers. This is a subsidy to the borrowers from B based on the amount of the withholding tax imposed on its payments to the U.S. entity. As such, it is not creditable under the codified regulations set forth above.[122]

The Conference Committee conferees intend that the amount of any withholding tax paid be "positively established through documentation" provided in accordance with §905(b) and Regs. §1.905-2. It is emphasized that the fact that withholding actually took place does not necessarily constitute proof of the amount of tax paid.[123]

The conferees expressed concern over possible abuses under the rule set forth in *Lederman v. Comr.*, 6 T.C. 991 (1946) suggesting that payment is proved ipso factor by the act of withholding.[124] In the case of a "net loan," for example, the agreement between the parties provides that the U.S., lender is to be paid a certain amount of interest net of any withholding by the tax authorities of the country of the borrower. Receipt of payment by the lender is not in and of itself proof that any amount has actually been withheld or the amount thereof.

The Report refers to cases in which amounts purportedly withheld are retained by the withholding agent, in whole or in part, with the explicit approval of the foreign government. It is therefore considered necessary in granting credit for taxes withheld on interest payments that a receipt or other positive proof of payment be submitted by the taxpayer.[125]

B. Limitations on Carrybacks to Pre-1987 Years

Due to the dramatic changes in U.S. tax rates and the elimination of the capital gains preferential tax rate, Congress deemed it necessary to provide special rules for the carryback of foreign excess foreign tax credits generated in years after 1986 to pre-1987 years. Act §1205(a)(1) provides that any such excess credits generated in post-1986 years may be carried back under §904(c) to pre-1987 years only to the extent that they are not attributable to the rate reductions effected by the 1986 Act. Also, regulations are authorized prescribing "proper adjustments" to the carrybacks authorized under Act §1205(a)(1) to take into account: (1) the repeal of the zero bracket amount, and (2) changes in the treatment of capital gains.[126]

Act §1205(b) provides that foreign taxes paid or accrued in a taxable year beginning after 1986 which, after the application of the above carryback rules, are treated as paid in a pre-1987 year will be treated as imposed on overall limitation income (under pre-enactment §904(d)). However, no carryback to pre-1987 years is permitted with respect to high withholding taxes imposed on interest. The Conference Committee added this provision to avoid the defeat of the purpose of the separate limitation for high withholding tax interest.

[120] Conf. Rep. at II-594.

[121] The Finance Committee Report, S. Rep. at 325, notes that the validity of these regulations is presently being challenged by a petition in the Tax Court, and states that no inference is to be drawn from this codification as to the validity of the regulations in question.

[122] Conf. Rep. at II-594.

[123] *Id.*

[124] *Id.*

[125] *Id.*

[126] Act§1205(a)(2).

Addendum to Chapter 59

INTERNAL REVENUE SERVICE ADVANCE NOTICE 87-6, ON TRANSITION RULES RELATING TO FOREIGN TAX CREDIT PROVISIONS OF THE TAX REFORM ACT OF 1986, RELEASED DEC. 24, 1986 (TEXT)

Part III — Administrative, Procedural, and Miscellaneous

Transitional Rules Relating to Amendments to the Foreign Tax Credit Provisions under the Tax Reform Act of 1986

Notice 87-6

The Internal Revenue Service today announced guidance relating to several aspects of the amendments made to the foreign tax credit rules by the Tax Reform Act of 1986 (the Act). The rules contained in this announcement will be incorporated in regulations to be issued under the 1986 Act. Taxpayers may rely on the rules provided herein for the purposes specified until regulations are issued.

Specifically, this announcement provides guidance with respect to: (1) the effective date of the amendments to section 904(d) generally; (2) the characterization of distributions and section 951(a)(1)(B) inclusions out of earnings and profits of a foreign corporation accumulated in a taxable year beginning before January 1, 1987, during taxable years of both the payor and recipient beginning after December 31, 1986, and the application of the rules for characterizing associated taxes paid or accrued by a foreign corporation; (3) the application of the effective date provisions and the look-through rules under section 904(d)(3) to distributions (including deemed distributions) and payments by a foreign corporation to a recipient during a taxable year of either the payor or the recipient that begins after December 31, 1986, and a taxable year of the other that begins before January 1, 1987; (4) transitional issues affecting the computation of the indirect foreign tax credit; (5) the grouping of items of income for purposes of determining whether income is high-taxed income under section 904(d)(2)(A)(iii)(III); and (6) clarification of the U.S. tax rate to be used in order to determine whether income is high-taxed income.

1. Application of the Effective Date Provision of Section 904(d)

Section 1201(e) of the Act provides that the amendments to section 904(d) are generally applicable to taxable years beginning after December 31, 1986. For purposes of applying the look-through rules under section 904(d)(3), the amendments to section 904(d) shall apply to distributions and section 951 inclusions of earnings and profits of a controlled foreign corporation derived during the first taxable year of the controlled foreign corporation beginning after December 31, 1986, and thereafter, and to payments made by a controlled foreign corporation during such taxable years, without regard to whether the corresponding taxable year of the recipient of the distribution or payment or of one or more of the U.S. shareholders of the controlled foreign corporation begins after December 31, 1986.

2. Characterization of Distributions and Section 951(a)(1)(B) Inclusions of Earnings of a Foreign Corporation Accumulated In Taxable Years Beginning Before January 1, 1987 During Taxable Years of Both the Payor Foreign Corporation and the Recipient Which Begin After December 31, 1986

Section 904(d)(2)(I) provides transition rules relating to the treatment of foreign tax credit carryovers from taxable years beginning before January 1, 1987. In general, those rules provide that pre-effective date unused foreign taxes on income subject to the general limitation shall be carried over to post-effective date years to reduce U.S. tax only on income subject to the general limitation. A special rule provides, however, that pre-effective date foreign taxes unused in pre-effective date years by reason of the general limitation may be used to reduce U.S. tax on post-effective date financial services income or shipping income, as the case may be, if the taxpayer establishes that these taxes were in fact paid or accrued with respect to that type of income. Taxes paid or accrued with respect to pre-effective date separate limitation interest income shall be carried over to offset U.S. tax on post-effective date income in the passive category. Taxes paid or accrued on any other type of pre-effective date separate limitation income (*e.g.*, DISC or FSC distributions) shall be carried over to offset U.S. tax on that type of income.

The effective date provisions of section 1201(e) of the Act do not provide rules relating to the characterization of distributions or section 951(a)(1)(B) inclusions out of earnings and profits accumulated in taxable years of a foreign corporation beginning before January 1, 1987, that occur after the effective date of the Act as applied to both the foreign corporation and the distributee or U.S. shareholder. Rules comparable to the rules contained in section 904(d)(2)(I) shall be applied for purposes of characterizing such distributions and section 951(a)(1)(B) inclusions and for purposes of characterizing foreign taxes deemed paid with respect to such distributions or section 951(a)(1)(B) inclusions.

As an initial matter, income derived by a foreign corporation in taxable years beginning before January 1, 1987, is characterized in the foreign corporation's hands under subparagraphs (A) or (E) of section 904(d)(1) (as in effect prior to the effective date of the Act) after application of the de minimis rule of section 904(d)(3)(C) (as in effect prior to the effective date of the Act). When, in a taxable year after the effective date of the Act, earnings and profits attributable to such income are distributed, or included in the gross income of a U.S. shareholder under section 951(a)(1)(B), the ordering rules of section 904(d)(3)(D), as in effect after the effective date, shall be applied to determine initially the character of the income of

the distributee or U.S. shareholder. Thus, a proportionate amount of a distribution described in this section will be initially characterized as separate limitation interest income in the hands of the distributee based on the ratio of the separate interest limitation earnings and profits out of which the dividend was paid to the total earnings and profits out of which the dividend was paid. The distribution or section 951(a)(1)(B) inclusion must then be recharacterized in the hands of the distributee or U.S. shareholder on the basis of the following principles:

(a) Distributions and section 951(a)(1)(B) inclusions that are initially characterized as income described in section 904(d)(1)(A) (as in effect prior to the date of enactment of the Act).

(b) Distributions and section 951(a)(1)(B) inclusions that the initially characterized as income described in section 904(d)(1)(E) (as in effect prior to the effective date of the Act) shall be treated as income described in section 904(d)(1)(I) (as in effect on and after the effective date of the Act), unless the taxpayer establishes to the satisfaction of the Commissioner that the distribution or section 951(a)(1)(B) inclusion is attributable to: (i) earnings and profits accumulated with respect to shipping income, as defined in section 904(d)(2)(D) (as in effect on and after the effective date of the Act); or (ii) in the case of an entity meeting the requirements of section 904(d)(2)(C)(ii) (an entity that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business), earnings and profits accumulated with respect to financial services income, as defined in section 904(d)(2)(C)(ii) (as in effect on and after the effective date of the Act).

(c) In order for a taxpayer to establish that distributions or section 951(a)(1)(B) inclusions that are attributable to earnings and profits that would otherwise be considered accumulated with respect to the general limitation in a particular taxable year beginning before January 1, 1987, are attributable to earnings and profits accumulated with respect to shipping or financial services income, the taxpayer must establish the amount of foreign taxes paid or accrued with respect to those earnings and profits that are to be treated as taxes subject to the separate limitation for shipping or financial services income, as the case may be, under section 904(d)(2)(I) (as in effect on and after the effective date of the Act). Conversely, in order for a taxpayer to establish the amounts of general limitation taxes paid or accrued in a taxable year beginning before January 1, 1987, that are to be treated as taxes paid or accrued with respect to shipping or financial services earnings and profits, as the case may be, the taxpayer must establish the amount of any distributions or section 951(a)(1)(B) inclusions that are attributable to earnings and profits that are accumulated with respect to shipping or financial services income.

3. Application of Look-through Rules to Distributions (Including Deemed Distributions) and Payments by a foreign Corporation to a Recipient When One's Taxable Year Begins Before January 1, 1987 and the Other's Taxable Year Begins After December 31, 1986

The effective date provisions of section 1201(e) of the Act do not include rules relating to the application of the look-through rules under section 904(d)(3) to payments made by a controlled foreign corporation during its taxable year beginning after December 31, 1986, but received in a taxable year of the recipient beginning before January 1, 1987. The provisions also do not address distributions (including deemed distributions) or payments made by a foreign corporation during its taxable year beginning before January 1, 1987, and received in a taxable year of the recipient beginning after December 31, 1986. This section provides rules to be applied in characterizing such distributions or payments.

(a) If interest, rents, or royalties are paid or accrued on or after the effective date of the look-through rules under new section 904(d)(3) as applied to the payor, but prior to the start of the recipient's first taxable year beginning after January 1, 1987, such interest, rents, or royalties shall initially be characterized in accordance with the new look-through rules. To the extent that interest payments in the hands of the recipient are initially characterized as passive income under these rules, they will be treated as separate limitation interest in the hands of the recipient. To the extent that rents or royalties in the hands of the recipient are initially characterized as passive income under these rules, they will be recharacterized as general limitation income in the hands of the recipient.

(b) If interest, rents, or royalties are paid or accrued before the effective date of the new look-through rules of section 904(d)(3) as applied to the payor, but on or after the start of the recipient's first taxable year beginning after January 1, 1987, the income in the recipient's hands shall be initially characterized in accordance with section 904(d)(3) as in effect prior to the effective date of the Act. To the extent interest income is characterized as separate limitation interest income under these rules, that income shall be recharacterized as passive income in the hands of the recipient. Rents or royalties will be characterized as general limitation income.

(c) If dividends are paid or accrued or section 951(a)(1) inclusions occur before the effective date of the new look-through rules of section 904(d)(3) as applied to the payor, but on or after the start of the first taxable year of the distributee or U.S. shareholder beginning after January 1, 1987, the dividends or section 951(a)(1) inclusions in the hands of the distributee or U.S. shareholder shall be initially characterized in accordance with section 904(d)(3) as in effect prior to the effective date of the Act, including the ordering rules of section 904(d)(3)(A) and (G). Therefore, under section 904(d)(3)(A) of prior law, dividends and section 951(a)(1) inclusions are considered to be paid or derived first from earnings attributable to separate limitation interest income. To the extent the dividend or section 951(a)(1) inclusion is initially characterized under these rules as separate limitation interest in the hands of the distributee or U.S. shareholder, the dividend or section 951(a)(1) inclusion shall be recharacterized as passive income in the hands of the distributee or U.S. shareholder. The portion, if any, of the dividend or section 951(a)(1) inclusion that is not characterized as passive income shall be characterized according to the rules in section (2). Therefore, a taxpayer may establish that income that would

otherwise be characterized as general limitation income is shipping or financial services income. Rules comparable to the rules contained in section 904(d)(2)(I) shall be applied for purposes of characterizing foreign taxes deemed paid with respect to distributions and section 951(a)(1) inclusions covered by this section.

The following examples illustrate the application of these principles:

Example (1). X is a domestic corporation that is a fiscal year taxpayer (July 1-June 30). FS, a controlled foreign corporation, is a wholly-owned subsidiary of X and has a calendar taxable year. On June 1, 1987, FS makes a $100 interest payment to X.

Because the payment is made after January 1, 1987 (the first day of FS's first taxable year beginning after December 31, 1986), the look-through rules of new section 904(d)(3) apply to characterize the payment made by FS. To the extent, however, that the interest payment to X is allocable to passive income earned by FS, the payment will be included in X's separate limitation for interest as provided in section 904(d)(1)(A) before the 1986 Act.

Example (2). X is a domestic corporation that is a calendar year taxpayer. FS, a controlled foreign corporation, is a wholly-owned subsidiary of X and has a July 1-June 30 taxable year. On June 1, 1987, FS makes a $100 interest payment to X.

Because the payment is made prior to July 1, 1987 (the first day of FS's first taxable year beginning after December 31, 1986), the look-through rules of new section 904(d)(3) do not apply. Assume that, under old section 904(d)(3), the interest payment would be characterized as separate limitation interest income. For purposes of determining X's foreign tax credit limitation, the interest payment will be included in X's separate limitation for passive income as provided in section 904(d)(1)(A) as amended by the 1986 Act.

Example (3). The facts are the same as in example (2) except that on June 1, 1987, FS makes a $100 dividend distribution to X.

Because the dividend is paid prior to July 1, 1987 (the first day of FS's first taxable year beginning after December 31, 1986), the look-through rules of new section 904(d)(3) do not apply. Assume that, under old section 904(d)(3), FS's earnings and profits for the taxable year ending June 30, 1987 consist of $200 of earnings attributable to general limitation income and $75 of earnings attributable to separate limitation interest income. The portion of the dividend that is attributable to FS's separate limitation interest and is treated as separate limitation interest income under old section 904(d)(3) is $75. The remaining $25 of the dividend is treated as general limitation income under old section 904(d)(3). For purposes of determining X's foreign tax credit limitation, $75 of the dividend will be recharacterized as passive income. The remaining $25 of the dividend will be characterized as general limitation income, unless X can establish that the general limitation portion is attributable to shipping or financial services income.

Although, in certain instances, income may be treated as passive or separate limitation interest income under this section, the rules provided in section 1205(b) of the Act operate independently of the rules discussed in this section. Section 1205(b) of the Act provides rules relating to foreign tax credit carrybacks with regard to taxes paid in taxable years beginning after 1986. Foreign taxes paid or accrued in a taxable year beginning after 1986 with respect to income other than high withholding tax interest that are carried back to a taxable year beginning before 1987 are treated as imposed on general limitation income without regard to whether the underlying income is, in fact, general limitation income.

4. Transitional Issues Affecting the Computation of the Indirect Foreign Tax Credit

Section 1202(a) and (b) of the Act amends sections 902 and 960 of the Code by replacing the annual ordering rules of prior law with ordering rules for post-1986 earnings and taxes based on perpetual pools. Subject to qualifications similar to those of prior law, post-1986 foreign income taxes paid by a foreign corporation may be treated as paid by a 10 percent domestic corporate shareholder in the same proportion as dividends that are paid out of post-1986 earnings bear to the foreign corporation's post-1986 undistributed earnings. As under prior law, post-1986 foreign income taxes paid by 2nd-tier or 3rd-tier foreign corporations are also deemed paid by a domestic corporate shareholder if certain qualifications contained in section 902(b) are met.

Section 902(c)(1) defines the term "post-1986 undistributed earnings" as the amount of earnings and profits of the foreign corporation (computed in accordance with sections 964 and 986) accumulated in taxable years beginning after December 31, 1986, determined as of the close of the taxable year of the foreign corporation in which the dividend is distributed without diminution by reason of dividends distributed during the taxable year. Section 902(c)(2) defines the term "post-1986 foreign income taxes" as the sum of (1) foreign income taxes with respect to the taxable year of the foreign corporation in which the dividend is distributed, and (2) the foreign income taxes with respect to prior taxable years beginning after December 31, 1986, to the extent such foreign taxes were not deemed paid with respect to dividends distributed by the foreign corporation in prior taxable years.

Section 1202(e) of the Act provides that the amendments made by section 1202 of the Act shall apply to distributions by foreign corporations out of, and to inclusions under section 951(a) of the Code attributable to, earnings and profits for taxable years beginning after December 31, 1986.

The following rules will apply with respect to the computation of the deemed-paid foreign tax credit under sections 902 and 960 as amended by the Act.

(a) *Sixty-day rule.* The sixty-day rule set forth in section 902(c) of the Internal Revenue Code, as in effect prior to the date of enactment of the Act, is not applicable to dividends paid during the first sixty days of a foreign corporation's first taxable year beginning after December 31, 1986.

(b) *Effective date rules for translating into U.S. dollars certain inclusions and indirect foreign tax credits.* For purposes of establishing the amount or character of income under sections 902, 951(a)(1)(B), and 1248, and the amount of indirect foreign tax credits under sections 902 and 960, earnings and profits of a foreign corporation accumulated in taxable years of the foreign corporation beginning before January 1, 1987, and foreign taxes deemed paid or accrued with respect to such earnings and profits under section 902 or 960, shall be determined and translated into dollars under the law in effect before the enactment of the Act. This rule applies regardless of the taxable year such amount is included in gross income by any shareholder of the foreign corporation.

(c) *Transition rules for certain distributions through tiers of foreign corporations.* For purposes of sections 902 and 960—

(i) Distributions by a 2nd-tier corporation with a functional currency (as defined in section 985(b)) other than the U.S. dollar that are out of earnings and profits accumulated in taxable years beginning after December 31, 1986, and included in the gross income of a 1st-tier corporation for any taxable year of the 1st-tier corporation beginning before January 1, 1987, shall be translated as necessary into the appropriate currency under the law in effect before the enactment of the Act. The foreign taxes paid or accrued by the 2nd-tier corporation with respect to such earnings and profits which are deemed paid by the 1st-tier corporation shall also be translated under the law in effect before the enactment of the Act.

(ii) Distributions by a 2nd-tier corporation that are out of earnings and profits accumulated in its taxable years beginning before January 1, 1987, and included in gross income of a 1st-tier corporation for any taxable year of the 1st-tier corporation beginning after December 31, 1986, shall be treated as post-1986 undistributed earnings (as defined in section 902(c)(1)) of the 1st-tier corporation. If the books and records of the 2nd-tier corporation are not kept in U.S. dollars, the foreign taxes paid or accrued by the 2nd-tier corporation with respect to such earnings and profits which are deemed paid by the 1st-tier corporation shall be translated into U.S. dollars at the spot rate for the date of distribution by the 2nd-tier corporation and treated as post-1986 foreign income taxes (as defined in section 902(c)(2)) of the 1st-tier corporation.

(iii) The rules in (i) and (ii) apply to a distribution from a 3rd-tier corporation to a 2nd-tier corporation by substituting "3rd-tier" for "2nd-tier" and "2nd-tier" for "1st-tier" in the preceding sentences.

5. Grouping of Items of Income for Purposes of the High-Tax "Kick Out"

Section 1201(a) of the Act amends section 904(d) of the Code by replacing the separate limitation for interest income with a separate limitation for passive income generally. under section 904(d)(2)(A)(iii)(III), high-taxed income is excluded from the category of passive income. Section 904(d)(2)(F) defines high-taxed income as any income which would otherwise be passive income but is not so treated because the sum of the foreign income taxes paid and deemed paid by the taxpayer with respect to that income exceeds the highest rate of tax specified in Section 1 or 11 of the Code multiplied by the amount of such income. Income is to be tested after allocation of expenses at the taxable level.

The following rules apply for purposes of grouping items of income in order to determine whether the items of income as grouped are high-taxed income:

(a) All interest, rents, and royalty payments received or accrued by the taxpayer from a particular controlled foreign corporation during the taxable year that are characterized (after application of the look-through rules of section 904(d(3)) as passive income shall be treated as one item of income:

(b) All passive income (determined after application of the look-through rules of section 904(d)(3)) included in the gross income of a U.S. shareholder under section 951(a)(1)(A) for a particular taxable year from each separate controlled foreign corporation shall be treated as a separate item of income.

(c) All passive rents and royalties not described in (a) or (b) that are received or accrued by a taxpayer during the taxable year shall be treated as one item of income; and

(d) All other passive income not described in (a), (b), or (c) that is received or accrued by a taxpayer during the taxable year shall be treated as one item of income.

The grouping rules described in (c) and (d) shall apply separately with respect to income attributable to each qualified business unit (as defined in section 989(a)) of a taxpayer if a taxpayer has more than one qualified business unit.

6. Applicable United States Tax Rate for 1987 with Respect to Determination of High-Taxed Income.

Section 904(d)(2)(F) defines high-taxed income with reference to the highest rate of tax specified in section 1 or section 11 of the Code. Similarly, section 954(b)(4) defines high-taxed income with reference to the section 1 or section 11 rates. For 1987, the tax rates in section 1 and section 11 are "blended" by virtue of the operation of section 15. Therefore, for purposes of sections 904(d)(2)(F) and 954(b)(4), the applicable tax rate for 1987 is the highest blended rate that applies to the taxpayer.

For further information contact Carol DuPuy (202-566-3289) or Marnie Carro (202-566-3499) regarding sections (1), (2), (3), (5) and (6), Kenneth Wood (202-566-6276) regarding section (4)(a) and Scott Farmer (202-566-3407) regarding sections (4)(b) and (c).

Chapter 60

TAX TREATMENT OF FOREIGN CURRENCY — §§985 - 989

William S. Corey, Esq., Leonard B. Terr, Esq.
Dennis L. Allen, Esq., Clifford E. Muller, Esq.
G. Garner Prillaman, Jr., Esq.
Sutherland, Asbill & Brennan
Washington, D.C.

I. Overview

A. Introduction

Prior to the Tax Reform Act of 1986 (the "Act"), there was no comprehensive set of rules governing the U.S. tax treatment of gain or loss from fluctuations in the value of foreign currency ("exchange gain or loss"). Guidance on such fundamental issues as the timing, amount, character and source of exchange gain and loss was provided, if at all, by a patchwork quilt of often inconsistent, sometimes confusing Internal Revenue Service rulings, court decisions and scattered Internal Revenue Code provisions and Treasury regulations. No clear authority existed even as to the characterization of currency as "foreign" in respect of a particular taxpayer's operations. Controversy surrounded such technical issues as the appropriate method to account for and translate the results of foreign currency-denominated branch operations; the appropriate exchange rates for translating branch remittances; dividends from, earnings and profits of, and foreign taxes paid or accrued by foreign subsidiaries; the includibility, character, and source of exchange gains or losses recognized on the repayment of foreign currency borrowings; and the proper characterization of foreign currency swaps and similar transactions.

The need for a comprehensive rationalization of the U.S. tax rules applicable to foreign currency was broadly addressed for the first time in December 1980, in the Treasury Department's *Discussion Draft on Taxing Foreign Exchange Gains and Losses*. The *Discussion Draft*, borrowing and elaborating on the "functional currency" concept first introduced in the same year as part of the Financial Accounting Standard Board's *Statement of Financial Accounting Standards No. 52: Foreign Currency Translation*, proposed fundamental changes in the tax rules governing both the translation of foreign branch and subsidiary results and the treatment of particular types of foreign currency transactions. Although provisions of the Economic Recovery Tax Act of 1981, the Technical Corrections Act of 1982, the Tax Equity and Fiscal Responsibility Act of 1982, and the Deficit Reduction Act of 1984, either were aimed at or had an impact upon particular types of foreign currency transactions, the prospect of comprehensive legislation in the area did not resurface in earnest until May 1985, when the *President's Tax Proposal to the Congress for Fairness, Growth and Simplicity* (Treasury II) singled out the area as a key tax reform priority and outlined a series of specific proposals building on the foundation earlier established in the *Discussion Draft*. An exhaustive study of the area, including a detailed response to the Administration's specific proposals, was issued by the Joint Committee Staff in July 1985. By year-end, the process which had begun five years earlier culminated in passage of the House Bill version of the foreign currency provisions and ultimately in enactment of a slightly modified version of those provisions as part of the 1986 Act.

The Act generally preserves the basic principles developed under the judicial authorities to the effect that foreign currency is "property" for U.S. tax purposes and that exchange gain or loss must be computed and reported separately and apart from the gain or loss on any underlying transaction. However, the Act amplifies such principles as relevant in both the translation and transactional contexts by providing a comprehensive set of rules designed to rationalize and clarify the state of the law in respect of foreign currency-denominated transactions and to establish consistent rules to govern the translation of foreign currency-denominated taxes and earnings and profits for foreign tax credit and related purposes.

B. Summary

1. Functional Currency

The Act generally requires a taxpayer to identify the primary operating currency (*i.e.*, "functional" currency) for each "qualified business unit" ("QBU") and to determine the unit's income or loss in the first instance in that currency. The use of a functional currency other than the U.S. dollar generally will preclude the recognition of exchange gain or loss in respect of the QBU's functional currency transactions, although gain or loss may be triggered by nonfunctional currency transactions or when the operations are liquidated or its profits are distributed. A QBU's functional currency is "the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records." Such functional currency will be the U.S. dollar if the QBU's activities are "primarily" conducted in U.S. dollars or, if they are not, the

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

determination generally will turn (subject to certain exceptions) on a facts and circumstances test as applied under the statute's "economic environment" standard. A QBU is defined as any "separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records." If the facts and circumstances could support more than one currency as the functional currency, the QBU generally may use any of such currencies as its functional currency so long as it maintains its books and records in such currency.

Even if a QBU's functional currency is other than the U.S. dollar, a taxpayer may elect, to the extent provided in regulations, to use the U.S. dollar as the QBU's functional currency if the QBU uses a method of accounting which approximates the separate transactions method or if its books and records are maintained in U.S. dollars. The election to use the U.S. dollar is effective for the taxable year when made and all subsequent taxable years, unless revoked with consent of the Secretary.

Any change in the functional currency of a QBU is treated as a change in method of accounting for §481 purposes, and may be subject to such additional conditions as the Secretary may prescribe.

2. Foreign Currency Transactions

The Act provides rules for determining the tax treatment of nonfunctional currency transactions ("§988 transactions"). The term "§988 transaction" means any of the following types of transactions if such transactions are denominated in a nonfunctional currency or are determined by reference to the value of one or more nonfunctional currencies:

(a) Acquisition of or becoming the obligor under a debt instrument, which, to the extent provided in regulations, includes preferred stock;

(b) Accruing (or otherwise taking into account for income tax purposes) any item of expense or gross income or receipt which is to be paid or received after the date in which so accrued or taken into account; or

(c) Entering into or acquiring any forward contract, futures contract, option or similar financial instrument (including a currency swap) if such instrument is not marked to market at the close of the taxable year under §1256. §988(c)(1)(B).

The term §988 transaction also includes the disposition of a nonfunctional currency, which for purposes of this definition includes coin or currency and nonfunctional currency-denominated demand or time deposits or similar instruments issued by a bank or other financial institution. The Act does not change the basic principle that for U.S. tax purposes, foreign currency is treated as "property" and gain or loss thus arises on its disposition to the extent of the difference between the basis of the currency and the amount realized. §988(c)(1)(C).

Foreign currency gain or loss is defined in §988(b) to include any gain or loss from a §988 transaction to the extent such gain or loss does not exceed gain or loss realized by reason of changes in exchange rates on or after the booking date and before the payment date. This definition of foreign currency gain or loss, as elaborated on in the Conference Report, appears to modify the prevailing view under pre-Act law that fluctuations in the value of foreign currency should be treated as a "separate transaction" producing taxable gain or loss separate and apart from any gain or loss attributable to the underlying transaction. The discussion in the Conference Report, at II-664, provides that "foreign currency gain or loss is recognized only to the extent of the total gain or loss, taking into account gain or loss on an underlying transaction." The significance of this language seems to be that, where there is a gain or loss on the underlying transaction, as well as offsetting foreign currency loss or gain, the two should be netted and only the excess amount of foreign currency loss or gain, if any, should be reported "separately." Such a netting approach could result in substantially different tax consequences than those produced under the pre-Act "separate transaction" method in regard to, for example, the character or source of the total gain or loss with respect to the transaction, as well as in regard to those Code provisions the operation of which is dependent on the gross income in respect of one or more transactions.

Foreign currency gain or loss attributable to §988 transactions generally is treated under the Act (subject to a narrow capital treatment election) as ordinary income or loss. The source of foreign exchange gain or loss treated as ordinary income or loss is to be determined by reference to the residence of the taxpayer or QBU on whose books the particular asset, liability, income or expense item is properly reflected.

The Act provides special rules for so-called "§988 hedging transactions," defined as a transaction entered into for the primary purpose of reducing risk of currency fluctuation with respect to property which is held or to be held, borrowings made or to be made or obligations incurred or to be incurred by the taxpayer, and which are identified by the Secretary or the taxpayer as a hedging transaction. To the extent provided in regulations, such transactions are to be integrated and treated as a single transaction or otherwise treated consistently. As explained in the Conference Report,[1] it is anticipated that the form of those hedging transactions which are part of an integrated economic package will be disregarded and that the various components of such transactions will be collapsed and treated in a manner consistent with the economic substance of the transaction. As to those hedging transactions which are not part of an integrated economic package, but rather are designed only to limit a taxpayer's exposure in a particular currency, the Conference Report anticipates that the form of the transaction may be respected but that regulations will provide for consistent treatment with respect to character, source and timing.

3. Foreign Currency Translation

The earnings and profits of a foreign corporation will be determined under the Act in the first instance in the corporation's functional currency. A foreign corporation which uses a functional currency other than the U.S. dollar is required to calculate its earnings and profits in such

[1] H.R. Rep. No. 841, 99th Cong., 2d Sess. (1986) ("Conference Report") at II-666.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

functional currency using the profit and loss method (rather than a net worth or specific transaction method) with only the resulting functional currency net profit or loss then being translated into U.S. dollars at the appropriate exchange rate.

In regard to actual distributions from a foreign corporation (and deemed distributions under §1248), the exchange rate on the date the distribution is included in income must be used to translate the amount of the distribution and the foreign corporation's earnings and profits from which the distribution is derived (*i.e.*, the post-1986 "pool" of earnings and profits per amended §902). Deemed distributions under Subpart F, personal holding company income and amounts included under §1293(a) are required to be translated using the weighted average exchange rate for the taxable year of inclusion. Further, a separate exchange gain or loss must be recognized if the exchange rate fluctuates between the time of a deemed distribution and an actual distribution of §959 or 1293 previously taxed earnings and profits. Any such gain or loss is to be treated as ordinary income or loss and sourced by reference to the source of the income which previously was deemed distributed.

In determining the amount of the deemed paid credit under §902 or 960, any foreign income taxes paid by a foreign corporation are to be translated into U.S. dollars using the exchange rate as of the time of payment. In the case of an upward adjustment in foreign taxes with respect to a prior year, the foreign taxes are required to be translated at the date the additional amount of taxes are paid. A refund or credit of foreign taxes with respect to a prior year is required to be translated using the exchange rate as of the time of original payment of such foreign taxes.

A foreign branch's taxable income or loss must be determined separately for each QBU in its functional currency. In addition, taxpayers are required to use the profit and loss method to translate the income or loss of a branch into U.S. dollars using weighted average exchange rates for the taxable year. The Conference Report, at II-675, contemplates that regulations will provide rules that, "in the case of a branch using a functional currency other than the [U.S.] dollar, will limit the deduction of branch losses to the taxpayer's dollar basis in the branch."

Under the Conference Report, at II-675, it is anticipated that remittances (whether of currency or other property) will trigger exchange gain or loss to the extent the value of the currency at the time of the remittance differs from the value when earned. Post-1986 remittances are deemed to be derived from post-1986 accumulated earnings on a pro rata basis. Any exchange gain or loss under the above rules is characterized as ordinary income or loss, sourced by reference to the source of the underlying income from which such remittance is derived. Foreign taxes paid in respect of branch operations are translated in the same manner as discussed above in regard to foreign taxes imposed on foreign corporations. §987(3) and (4).

4. Miscellaneous Provisions

A "position" for purposes of the §1092 straddle provisions is defined under the Act to include an obligor's interest in a nonfunctional currency-denominated debt obligation. In addition, for purposes of the "actively traded" requirement in respect of the definition of personal property under §1092(d)(1), foreign currency for which there is an active interbank market is presumed to be actively traded. Act §1261(b). The banking exception under §1256(e)(4) from certain requirements of the §1256(e) hedging exception is repealed. Act §1261(c).

Treasury is instructed to prescribe regulations:

(a) setting forth procedures to be followed by taxpayers with QBUs using a net worth method before the enactment of the Act's foreign currency provisions;

(b) limiting the recognition of losses in regard to certain remittances from QBUs;

(c) providing for the recharacterization of interest and principal payments with respect to obligations denominated in certain hyperinflationary currencies;

(d) providing for alternative adjustments to the application of §905(c); and

(e) providing for the appropriate treatment of related party transactions (including transactions between qualified business units of the same taxpayer). §989(c).

C. *Effective Date*

The above provisions generally are effective for taxable years beginning after December 31, 1986, but for purposes of claiming a deemed paid foreign tax credit under either §902 or 960, the provisions apply only to earnings and profits of a foreign corporation for taxable years beginning after 1986 and to foreign taxes paid or accrued by the foreign corporation with respect to such earnings and profits. Act §1261(e).

II. Detailed Analysis

A. *Functional Currency*

Section 1261 of the Act adds new Code §985, which adopts the concept of a functional currency by providing in general that all determinations for U.S. income tax purposes are to be made in a taxpayer's functional currency.

1. Background

Prior to the Act, there were no statutory rules permitting the selection of a currency other than the U.S. dollar as a base currency or frame of reference for use in determining the income or loss of a foreign operation, whether in corporate or noncorporate form, for U.S. tax purposes.[2] Stated differently; there were no definitive criteria for characterizing a currency other than the U.S. dollar as a "home" currency, or medium of exchange, whose extrinsic value would be considered fixed over time, so that transac-

[2] Various methods of translating the income or loss of foreign operations into U.S. dollars, including the net worth and profit and loss methods, have been approved by the IRS and the courts; *see, e.g.*, Rev. Rul. 75-107, 1975-1 C.B. 32; Rev. Rul. 75-106, 1975-1 C.B. 31; *American Pad and Textile Co. v. Comr.*, 16 T.C. 1304 (1951); *Frederick Vietor & Achelis v. Salt's Textile Mfg. Co.*, 26 F.2d 249 (D. Conn. 1928) but there is no authority with respect to the selection of a base or home currency for the initial reporting of such operations prior to conversion to the U.S. dollar.

tions in such currency would not give rise to the recognition of exchange gain or loss.

While the profit and loss method perhaps most closely approximated a "home" currency concept, that method was never codified, was susceptible of widely divergent applications in practice, was but one of several optional methods for accounting for the results of foreign operations, and was unavailable to controlled foreign corporations (CFCs). In the later connection, CFC operations were required to be accounted for under a combination net worth and specific transactions method that had the effect of treating the CFC from the foreign currency standpoint as if it were a mere extension of its dollar-based U.S. shareholders. Under applicable rulings, non-CFC foreign corporations were in effect similarly treated for earnings and profits purposes. Moreover, there was no clear guidance as to when a particular foreign operation became sufficiently identifiable as a separate economic unit to permit its results to be determined for U.S. tax purposes under a profit and loss method on the basis of a "home" currency different from the currency of other related economic units.

The provisions of §985 were designed to resolve these and related issues by establishing a general rule that all determinations for U.S. income tax purposes (*e.g.*, computations of taxable income or loss, earnings and profits) are to be made by a taxpayer in a base or home currency to be known as the taxpayer's "functional currency." The functional currency concept was originally introduced in a Financial Accounting Standards Board Exposure Draft issued in August 1980 ("the Exposure Draft").[3] The Exposure Draft, which outlined a comprehensive proposal with respect to accounting for foreign currency transactions, was later adopted as Statement of Financial Accounting Standards No.52 ("FASB No. 52").[4] The functional currency principle of the Exposure Draft was adopted by the Treasury, without substantial modification, in a Discussion Draft issued on December 8, 1980 outlining a proposal for the taxation of foreign currency gains and losses, and later became part of the President's Tax Proposals issued in May 1985.[5]

The basic premise underlying the functional currency concept of §985 is that the income or loss of a business unit is most accurately computed using the currency of the economic environment in which such unit operates. Unrealized exchange gain or loss resulting from the balance sheet impact of exchange rate fluctuations between the functional currency and the U.S. dollar is not taken into account because under the functional currency approach income or loss is determined on the basis of the functional currency income statement. Exchange gain or loss thus can arise, and will be taken into account in determining profit or loss, only when realized upon the settlement of nonfunctional currency transactions or upon the distribution of profits or the liquidation of the operation.

The functional currency of a particular business operation generally is determined with reference to the "economic environment" in which such business operation is conducted. Although each separate business operation ("qualified business unit") may have only one functional currency, a particular taxpayer can have more than one functional currency if it operates within more than one economic environment. As noted, transactions in a currency other than the functional currency may (and generally will) give rise to exchange gain or loss measured in functional currency terms. However, no exchange gain or loss is recognized as a result of functional currency transactions; rather, income or loss is determined in the first instance in functional currency terms and is only then (in the case of U.S.-owned foreign operations) translated into U.S. dollars at appropriate exchange rates. For example, if the functional currency of a Swiss branch of a U.S. corporation is the Swiss franc, income or loss of the branch would be determined initially in francs based on the branch's Swiss franc income statement and then translated into U.S. dollars for purposes of determining (among other things) U.S. dollar income or loss. Transactions conducted by the branch in currencies other than the franc, including U.S. dollar transactions, would trigger recognition of exchange gain or loss, measured in franc terms, that would be reflected in the branch's income statement and thereby taken into account in determining net income or loss for U.S. tax purposes.

2. *General Rules*

Section 985(a) requires that all determinations for U.S. income tax purposes are to be made in a taxpayer's functional currency, unless otherwise provided in regulations. Section 985(b)(1) provides that a taxpayer's functional currency is either (i) the U.S. dollar or, (ii) in the case of a "qualified business unit" ("QBU"), "the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records." In effect, §985(b)(1) requires taxpayers to use the U.S. dollar as the functional currency in respect of all foreign operations that do not satisfy the statutory definition of a QBU. Where a particular foreign operation *does* satisfy the QBU definition, the functional currency of such QBU generally will be the currency of the "economic environment" in which its operations are conducted, provided the QBU also maintains its books and records in such currency.

An election to use the U.S. dollar as the functional currency is available under §985(b)(3), subject to certain conditions, to taxpayers whose operations might otherwise be required to use another currency. The choice of a functional currency is treated under §985(b)(4) as a method of accounting, which can be changed only with the consent of the Secretary.

3. *Definition of a QBU*

A QBU is defined by §989(a) as "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records." The Senate

[3] Financial Accounting Standards Board Exposure Draft, *Foreign Currency Translation* (August 28, 1980).

[4] Statement of Financial Accounting Standards No. 52, *Foreign Currency Translation*, issued by the Financial Accounting Standards Board (December 7, 1981).

[5] *See* U.S. Treasury Department, *Discussion Draft on Taxing Foreign Exchange Gains and Losses*, 45 Fed. Reg. 81,711 (Dec. 11, 1980); U.S. Treasury Department, *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity* 415 (May 1985).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Report indicates that a single taxpayer can have more than one QBU.[6]

In order to constitute a "separate and clearly identified unit of a trade or business of a taxpayer" within the meaning of §989(a), both the House and Senate Reports[7] indicate that the unit must include every operation that forms a part of the process of earning income. In other words, the unit must constitute an independent economic enterprise carried on for profit, encompassing every constituent operation or step in the enterprise's income-generating process, including the collection of income and the payment of expenses. The House Report provides the following example to illustrate the principle that a unit will not qualify as a QBU where it does not include every operation that forms a part of the process of earning income:

> For example, assume a corporation that manufactures and sells product X in the United States decides to establish an office in France. The French office maintains one salesperson whose only function is to solicit orders for product X, and the remaining sales functions continue to be conducted in the United States. On these facts, the activity of the French office would not be viewed as giving rise to a qualified business unit of the corporation.[8]

It is not necessary that the operations of a business unit be considered a separate trade or business within the meaning of §446(d) in order for the unit to constitute a QBU. Stated differently, a QBU will not necessarily qualify as a separate "trade or business" for purposes of permitting a taxpayer to use different methods of accounting. Rather, the statutory definition of a QBU may be satisfied on the basis of vertical, functional or geographic divisions of a single trade or business, if each such division is capable of independently producing income.[9] Because the QBU definition is narrower in scope than the §446(d) concept of a trade or business, different QBUs of a taxpayer may be permitted to utilize different functional currencies but nevertheless may be required to adhere to the same accounting methods for all other purposes.

Section 989(a) also requires that a business operation maintain separate books and records in order to constitute a QBU (as discussed below).

4. Economic Environment of QBU

Section 985(b)(1) provides that if a business unit satisfies the QBU definition of §989(a), its functional currency will be "the currency of the economic environment in which a significant part of such unit's activities are conducted."

a. U.S. Dollar Economic Environment

(1) Business Conducted Primarily in U.S. Dollars

Section 985(b)(2) provides that the economic environment of a QBU conducting its business primarily in U.S. dollars is deemed to be the United States and therefore the U.S. dollar must be used as the functional currency of the QBU. The House and Senate Reports provide two examples, originally set forth in the Exposure Draft, which illustrate the principle that a QBU conducting its business primarily in U.S. dollars must use the dollar as its functional currency:[10]

> *Example*: A U.S. taxpayer incorporates a wholly owned subsidiary in Switzerland. All books of record are maintained in Swiss francs, and the Swiss franc is used as the functional currency for financial reporting purposes. The Swiss company is primarily a base company selling the exports of its U.S. parent corporation, and virtually all of its income is foreign base company sales income within the meaning of §954(d). Most of its transactions are denominated in U.S. dollars or, less frequently, in foreign currencies other than the Swiss franc.

Under the Act, the U.S. dollar is the functional currency of the Swiss company even though its books of record are maintained in Swiss francs and the Swiss franc is the functional currency for financial reporting purposes. This result obtains because the Swiss company's activities are primarily conducted in U.S. dollars.

> *Example*: A bank incorporated and with its head office in the United States has a branch in a foreign country. Although the foreign country requires the branch to keep books in the local currency, the branch customarily fixes the terms of its loans to local customers by reference to a contemporary London Inter-Bank Offered Rate (LIBOR) on dollar deposits (*e.g.*, the interest rate on outstanding loan principal equals LIBOR plus 2% and outstanding loan principal is adjusted to reflect changes in the dollar value of the local currency). Local lending is, in turn, typically funded with dollar-denominated funds borrowed from the head office, other branches and subsidiaries of the same bank, and independent lenders. In turn, the branch lends dollars. The bank elects to use the dollar, not the local currency, as the functional currency of the branch for federally mandated financial reporting purposes.

In this instance, although the branch maintains its books and records of operation in foreign currency, the branch's activity is conducted primarily in the U.S. dollar. Under the Act, the branch is a qualified business unit and the dollar is the functional currency for tax purposes.

(2) "Sufficient Commitment" Rule

The Senate Report, at 456, indicates that a QBU will be considered to operate in a non-U.S. dollar economic environment, and thus will be permitted to adopt a non-U.S. dollar functional currency, only if the QBU represents a "sufficient commitment" (alternatively described in the Senate Report as a "long-term commitment") to the economic environment of the host country. If the required commitment to the local jurisdiction does not exist, the economic environment of a QBU operated by a U.S. corporation is deemed, in effect, to be the United States and thus the functional currency of the QBU will be the U.S. dollar.

[6] S. Rep. No. 313, 99th Cong., 2d Sess. 457 (1986) ("Senate Report").
[7] H.R. Rep. No. 426, 99th Cong., 1st Sess. 472 (1985) ("House Report"); Senate Report at 457.
[8] *Id.*
[9] House Report at 472; Senate Report at 457.
[10] House Report at 473; Senate Report at 458.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

In this regard, a foreign operation of limited duration conducted by a U.S. corporation ordinarily will not be viewed as meeting the "sufficient commitment" test and thus the economic environment of the operation ordinarily will be considered the United States. The Conference and Senate Reports give as an example of such an operation an offshore construction project undertaken by a U.S. taxpayer.[11] Although not specifically addressed in the legislative history, the "sufficient commitment" rule would also seem to require a QBU operated by a foreign person to adopt the functional currency of such person if the QBU did not have a sufficient commitment to another local jurisdiction.

The Conference Report does note, however, that the *existence* of a QBU (as distinguished from its "economic environment") does not turn "solely" on the time frame of a foreign activity.[12] The Report states that "in appropriate circumstances (*e.g.*, if the activity is subjected to tax in the host country), an activity of sufficient duration (*e.g.*, 12 months) may support the finding of the existence of a QBU."[13] Although this statement is directed at the QBU definition itself, rather than at the economic environment test for determining such QBU's functional currency, it nevertheless could be read to provide indirect support for the proposition that the determination of the economic environment of a QBU should be based on all relevant facts and circumstances and that the duration of (or the payment of local taxes by) a foreign operation should be considered together with other factors in determining the sufficiency of the business operation's commitment to the local jurisdiction for purposes of the economic environment test. It remains to be seen, however whether Treasury and the IRS ultimately will concur in this interpretation.

(3) The "Integral Extension" Exception

The Conference Report provides that the economic environment of a QBU will be deemed to be the same as that of the U.S. corporation that owns the QBU, and thus that the QBU's functional currency will be the same as the U.S. corporation's, if the QBU is merely an "integral extension" of such U.S. corporation.[14] The Report cites as examples (based on examples contained in the Exposure Draft, footnote 2 *supra*) of operations that would be viewed as integral extensions of a U.S. operation: (i) a foreign corporation whose sole function is to act as a financing vehicle for affiliated U.S. corporations, and (ii) a foreign corporation used to hold portfolio stock investments or similar passive assets that could as easily be held by the U.S. parent corporation.[15] The "integral extension" rule would also seem to apply where a QBU is an integral extension of a foreign corporation or other foreign person. In this regard, the Senate Report provides that if a business unit is an integral part of a larger operation, the economic environment of the larger operation governs the choice of the business unit's functional currency.[16]

Although not specifically mentioned in the legislative history, paragraph 70 of the Exposure Draft (footnote 2 *supra*) provides the following additional examples of situations in which a particular foreign operation is considered (for financial accounting purposes) to be an integral extension of a U.S. operation:

> *Example 1*: A foreign division, branch, or subsidiary that primarily manufactures a subassembly that is then shipped to a U.S. plant for inclusion in a product sold to customers located in the United States or in different parts of the world.
>
> *Example 2*: A foreign shipping subsidiary that primarily transports ore from the U.S. company's foreign mines to the United States for processing in the U.S. company's U.S. smelting plants.
>
> *Example 3*: A foreign sales branch or subsidiary of a U.S. manufacturer that primarily takes orders from foreign customers for U.S. manufactured goods, that bills and collects from foreign customers, and that might have a warehouse to provide for timely delivery of the product to those foreign customers. (In substance, this foreign operation may be the same as the export sales department of a U.S. manufacturer).

b. Facts and Circumstances Test

The economic environment of a QBU (if not deemed to be the United States pursuant to the rules described above) generally is determined under a facts and circumstances test.[17] In making the required determination, the Senate Report provides that the factors to be taken into account should include (but are not limited to): (i) the currency in which the unit's books and records are maintained; (ii) the principal currency in which revenues and expenses are generated; (iii) the principal currency in which the unit borrows or lends; and (iv) the functional currency of related business units and the extent to which the unit's operations are integrated with related business units.[18] (Because the maintenance of books and records in a particular currency is a statutory prerequisite for treating such currency as a functional currency, the "books and records" requirement technically should not be viewed as part of the "facts and circumstances" test employed to determine an economic environment, but rather as a separate requirement which must be satisfied in order that the currency of the economic environment qualifies under §985(b)(1)(B) as the functional currency.)

The Senate Report cites FASB No. 52 (footnote 3 *supra*) and indicates that the factors enumerated above generally correspond to those used in making the determination for financial accounting purposes. The factors are stated somewhat differently in FASB No. 52, at paragraphs 80 and 81 thereof, as follows:

> "80. In the first class [where the functional currency is a foreign currency] are foreign operations that are relatively self-contained and integrated within a particular country or economic environment. The day-to-day operations are not dependent upon the economic environment of the parent's functional currency; the foreign operation primarily generates and expends

[11] Conference Report at II-600; Senate Report at 456.
[12] Conference Report at II-660.
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] Senate Report at 457.
[17] *Id.*
[18] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

foreign currency. The foreign currency net cash flows that it generates may be reinvested or converted and distributed to the parent.

"81. In the second class [where the functional currency is the U.S. dollar] are foreign operations that are primarily a direct and integral component or extension of the parent company's operations. Significant assets may be acquired from the parent enterprise or otherwise by expending dollars and, similarly, the sale of assets may generate dollars that are available to the parent. Financing is primarily by the parent or otherwise from dollar sources In other words, the day-today operations are dependent on the economic environment of the parent's currency, and the changes in the foreign entity's individual assets and liabilities impact directly on the cash flows of the parent company in the parent's currency."

If the facts and circumstances could support treatment of more than one jurisdiction as the QBU's economic environment, and thus ultimately could support the use as a functional currency of any of two or more qualifying currencies, the Senate Report indicates that a taxpayer may adopt any of such currencies as the QBU's functional currency at its discretion.[19] The Senate Report describes the following situation as an example illustrating the operation of this principle:

"A U.S. parent corporation, P, has a wholly owned U.S. subsidiary, S, whose head office is in the United States, although its primary activity is extracting natural gas and oil through a branch in a foreign country. Sales of natural gas and oil are billed in both U.S. dollars and local currency, and significant liabilities and expenses (*e.g.*, loan principal and interest) are denominated in both dollars and local currency. The foreign country requires the branch to keep its books and records in the local currency. In filing federally mandated financial statements, P and S elect to use the dollar, not the local currency.

"Absent other factors pointing to the predominance of the dollar (such as a high volume of intercompany activities with dollar-based affiliates or a U.S. sales market), the facts do not clearly require the specification of a particular currency. In such a case, the taxpayer would have discretion in choosing between the dollar and the local currency." [20]

c. Volume of Local Currency Activities

It is not clear under the "economic environment" standard of §985(b)(1)(B) whether a QBU which is located in a foreign jurisdiction, but which conducts no (or virtually no) business activity in the currency of such jurisdiction, could nevertheless adopt the local currency as its functional currency. Under the House Bill (H.R. 3838), a QBU's functional currency was determined not by reference to the *economic environment* in which a significant part of its business activities are conducted, but to *the currency* in which a significant part of such operations are conducted, and it therefore seems clear that under the House Bill substantial business activities in the local currency would have been required.

Although the "economic environment" standard of the Senate bill was adopted in Conference, the Conference Report could be read to contemplate local currency activity; it states that "[i]n general, the rule for QBUs will apply where the foreign operation constitutes a trade or business, a significant part of the activities of which are conducted in the local currency." [21] On the other hand, it may be that the Conference Report language was intended only to reflect the general rule and that, in appropriate situations, no local currency activity is required in order to meet the economic environment test. Such an interpretation also could be supported by the Senate Report, which notes that a taxpayer may be eligible to account for the results of a foreign operation by measuring income or loss in the currency of the host country (or, in appropriate circumstances, another foreign country).[22] The meaning of the parenthetical reference to another foreign currency is not clear, however, and may refer only to the situation in which a foreign operation is an integral part of the operations of another foreign operation and (as earlier discussed) would be required to use as its functional currency the currency of such other operation.

5. Books and Records Requirement

In order for a currency to constitute the functional currency of a QBU, §985(b)(1)(B) requires the QBU to maintain its books and records in such currency. If books and records are not so maintained, the operation will not qualify as a QBU and thus its functional currency will be the U.S. dollar (or other foreign currency in the case of a non-U.S. dollar owner of the foreign operation).

If the economic environment of a QBU is the local jurisdiction and the QBU is required by such jurisdiction to maintain local currency books and records, then (subject to the election to use the U.S. dollar discussed at 6 *infra*) §985(b)(1)(B) generally requires the QBU to use the local currency as its functional currency. On the other hand, if the QBU is not required to maintain local currency books and records, it can, in effect, elect to use either the local currency or the U.S. dollar as its functional currency. If local currency books and records are maintained, §985(b)(1)(B) requires the QBU to use the local currency. If, on the other hand, the QBU does not maintain local currency books and records, the §985(b)(1)(B) requirement will not be satisfied and the general rule of §985(b)(1)(A) will mandate the use of the U.S. dollar (or, in appropriate cases, other foreign currency) as the functional currency.

Where the economic environment of a QBU is not the local jurisdiction, but is another foreign country (or the economic environment is unclear and the QBU elects the economic environment of another foreign country), the functional currency of the QBU is the currency of such other country, provided the QBU maintains its books and records in such currency. If the QBU is required by the local jurisdiction (or elects) to keep local currency books

[19] *Id.*
[20] Senate Report at 458.
[21] Conference Report at II-660.
[22] Senate Report at 456.

and records, then the U.S. dollar is the QBU's functional currency (since the QBU failed to maintain books and records in the currency of its economic environment) unless (i) the QBU is allowed under §985(b)(1)(B) to satisfy the functional currency requirement by maintaining a second set of books and records in the appropriate currency or (ii) books and records maintained in the appropriate currency by the parent or other affiliate, if any, of the QBU could be attributed to the QBU for purposes of satisfying the books and records requirement. The legislative history does not address the issue of whether a second set of books can be maintained by a QBU in order to satisfy the requirements of §985(b)(1)(B) for adoption of a non-dollar functional currency. It is clear, however, that a second set of books and records is contemplated under §985, with respect to a QBU required to keep local currency books and records, in order for such QBU to make the U.S. dollar functional currency election (discussed at 6 *infra*). The requirements of §985(b)(1)(B) literally would be satisfied if a second set of books and records were maintained and no sound reason is evident why a local currency books and records requirement should be determinative of a QBU's functional currency. Section 985(b)(1)(B), in referring to the books and records requirement applicable to a QBU, provides that the functional currency of the QBU is "the currency . . . which is *used by such unit* in keeping its books and records." It would seem, therefore, based on the language of the statute, that each QBU must actually maintain the appropriate books and records and that maintenance of such books and records by the parent or other affiliate of the QBU would not suffice.

If the economic environment of a QBU is the United States, pursuant to the rules discussed above (*e.g.*, the QBU is an integral extension of a U.S. business), §985 does not seem to require that the QBU maintain books and records in U.S. dollars. If books and records are not maintained by the unit in dollars, the technical requirements of §985(b)(1)(B) (*i.e.*, currency of economic environment and books and records are the same) are not satisfied and the functional currency is deemed to be the U.S. dollar pursuant to the general rule of §985(b)(1)(A) (which does not, however, require the local unit to maintain U.S. dollar books and records). Books and records in dollars would have to be developed (if not currently maintained) and maintained by either the QBU or its U.S. affiliate, however, so that the QBU's income or loss could be computed, as required by the Act, on the basis of its functional currency profit and loss statement.

6. Election to Use U.S. Dollar

Section 985(b)(3) allows a taxpayer, to the extent provided in regulations, to elect to use the U.S. dollar as the functional currency of any QBU if the QBU keeps its books and records in dollars or, in certain limited situations (discussed below), the taxpayer uses a method of accounting to translate the income of the QBU that approximates a separate (or specific) transactions method. As stated above, a taxpayer operating in a local jurisdiction that does not require the maintenance of local books and records can, in effect, elect to use the U.S. dollar as the functional currency of the QBU by keeping its books and records in dollars (or in any currency other than the currency of the economic environment in which the QBU operates). Section 985(a)(3) was probably designed, therefore, to cover the situation where a QBU whose economic environment is the local jurisdiction is required under local law to maintain its books and records in local currency. In such a case, the taxpayer would satisfy the literal requirements of §985(b)(1)(B) and, absent the exception, would be required to use the local currency as its functional currency.

The Senate and Conference Reports [23] indicate that a QBU will satisfy the statutory requirement for election of the dollar (*i.e.*, that it maintain books and records in U.S. dollars) only if such books and records compute income or loss in U.S. dollars on a transaction-by-transaction (*i.e.*, separate or specific transactions) method. If a QBU does not maintain its books and records in U.S. dollars in accordance with this method of accounting, it may still elect the dollar as its functional currency if the U.S. dollar income of the QBU is computed using "a method of accounting that approximates a separate transactions method." The Conference Report states, however, that the Secretary may condition the application of this "approximate method" exception to the dollar-based books requirement by requiring the comparison of year-end balance sheets using historical exchange rates for all balance sheet items.[24]

More fundamentally, the Conference Report also makes clear that the election to use the U.S. dollar as the taxpayer's functional currency based on an "approximate separate transactions" method was aimed primarily at taxpayers operating in hyperinflationary economies.[25] In regard to operations in such economies, the Conference Report indicates that local currency based accounting might not accurately reflect the income or loss of a taxpayer with substantial fixed plant and equipment because the local currency depreciation charge (which is based on historical cost) will become insignificant in relation to operating income.[26] The Conference Report states that the election should not be generally available outside the hyperinflationary economy area.[27]

As stated above, the ability of a taxpayer to elect the U.S. dollar by keeping dollar books and records or invoking the "approximate separate transactions" method exception is subject to regulations to be promulgated. Although the intended scope of such regulations is unclear, the Conference Report specifies that the Secretary may condition the election to use the U.S. dollar on the taxpayer's making such election for all QBUs (on a worldwide basis).[28]

Section 985(b)(3) provides that an election to use the U.S. dollar is effective for the taxable year for which made and all subsequent taxable years, unless revoked with the consent of the Secretary. The Conference Agreement established rules with respect to the procedure and timing of such election. For a U.S. person, the election is to be made on the return for the first taxable year for which a QBU

[23] Conference Report at II-661-2; Senate Report at 459.
[24] Conference Report at II-661.
[25] Conference Report at II-661-2.
[26] *Id.*
[27] *Id.*
[28] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

exists, by making a statement that the QBU elects the U.S. dollar as its functional currency for U.S. tax purposes. For a foreign person, the election is to be made in the U.S. owner's return for the first taxable year in which the U.S. owner acquires at least a 50% ownership interest in the foreign person by making a statement that the foreign person's QBU elects the U.S. dollar as its functional currency for U.S. tax purposes. If there is no 50% U.S. shareholder, regulations are to provide a mechanism for the election on the occurrence of a significant event (*i.e.*, an event having U.S. tax consequences).[29]

7. Exception to General Rule That Transactions Be Accounted for in Functional Currency Terms

Section 985(a) grants to the Secretary the regulatory authority to except certain transactions from the general rule that all determinations for U.S. tax purposes are to be made in functional currency terms. The Conference Report indicates that the authority should be used to prescribe rules for the accrual of original issue discount and bond premium in nonfunctional currency terms.[30] The Report also states that pending the issuance of such regulations, original issue discount and bond premium with respect to foreign currency obligations are to be determined in terms of units of the nonfunctional currency, with such units being translated into the taxpayer's functional currency using an average exchange rate for the accrual period.[31] The Conference Report also provides that where appropriate, the Secretary may require that dollar transactions by a QBU with a non-dollar functional currency be accounted for in dollars.[32]

8. Functional Currency Treated as an Accounting Method

Section 985(b)(4) provides that any change in the functional currency or currencies of a taxpayer is treated as a change in method of accounting subject to the rules of §481. In addition, the Conference Report indicates that any such change is subject to such conditions as the Secretary may prescribe.[33] The Senate Report indicates that regulations are to be promulgated to cover the situation where the functional currency of a taxpayer involuntarily changes,[34] presumably as the result of a change in the economic environment in which such taxpayer is operating.

Because a trade or business may consist of a number of QBUs, each with a different functional currency (and thus under §985(b)(4) a different method of accounting), §985(b)(4) is a departure from the general rule that all components of a single trade or business must use the same method of accounting. In an apparent effort to ensure a measure of consistency between QBUs in the same trade or business, however, the Senate Report provides that a taxpayer must use consistent criteria for identifying the functional currency of QBUs engaged in similar activities in different countries.[35] While each QBU comprising a single trade or business of a taxpayer is allowed to use a different functional currency, all other methods of accounting for all QBUs conducting a single trade or business must be consistent.

B. Foreign Currency Transactions

1. Background

The Act provides the first set of comprehensive statutory rules regarding the tax treatment of foreign currency transactions (*i.e.*, nonfunctional currency transactions). Prior to the Act, the rules regarding the tax treatment of such transactions were in many instances inconsistent and in some respects confused, with such fundamental issues as the timing, amount, character and source of exchange gain or loss in regard to a variety of transactions remaining unsettled. The inconsistency and confusion surrounding such rules in many instances were the result of the application of two "basic principles" in regard to foreign currency transactions which have been developed in the relevant judicial authorities.

One such "basic principle" is that foreign currency is treated as "property" for U.S. tax purposes.[36] As property, a taxpayer establishes a basis in foreign currency for U.S. tax purposes and may recognize gain or loss under normal §1001 principles if the amount realized in respect of a disposition of the foreign currency exceeds or is less than such basis. Since U.S. taxpayers generally engage in foreign currency transactions in which the foreign currency is used as a medium of exchange rather than as property, the U.S. tax rules applicable to property transactions in many instances produced either inappropriate or unclear consequences under pre-Act law. The Act does not alter the "currency as property" principle, but rather provides a set of rules which clarify the consequences of particular foreign currency transactions.

The second "basic principle" which has been developed in the relevant judicial authorities is that exchange gain or loss should be reported separately and apart from any gain or loss in respect of any underlying transaction (*i.e.*, the "separate transaction" principle).[37] Thus, for example, in

[29] Conference Report at II-662.
[30] Conference Report at II-658.
[31] *Id.*
[32] Conference Report at II-660.
[33] Conference Report at II-661.
[34] Senate Report at 458.
[35] Senate Report at 457.

[36] *See, e.g., Gillin v. U.S.*, 423 F.2d 309, 311 (Ct. Cl. 1970); *KVP Sutherland Paper Co. v. U.S.*, 344 F.2d 377 (Ct. Cl. 1965); *The B.F. Goodrich Co. v. Comr.*, 1 T.C. 1098 (1943); *North American Mortgage Co. v. Comr.*, 18 B.T.A. 418 (1929); *Wheat v. Comr.*, 8 B.T.A. 1246 (1927).

[37] *National Standard Co. v. Comr.*, 80 T.C. 551 (1983), aff'd 749 F.2d 369 (6th Cir. 1984); *KVP Sutherland Paper Co. v. U.S.*, 344 F.2d 377 (Ct. Cl. 1965); *Willard Helburn Inc. v. Comr.*, 20 T.C. 740 (1953), aff'd 214 F. 2d 815 (2d Cir. 1954), *Mariani Frozen Foods Inc. v. Comr.*, 81 T.C. 448 (1983) aff'd *sub nom*, 761 F.2d 1410 (1985); *American-Southeast Asia Co., Inc. v. Comr.*, 26 T.C. 198 (1956); *Bernuth Lemboke Co. v. Comr.*, 17 B.T.A. 599, acq., IX-1 C.B. 5; *Joyce-Keobel Co. v. Comr.*, 6 B.T.A. 403 (1927); acq., VI-2 C.B. 4 (1927); PLR 8141104 (July 20, 1981); *see also* PLR 7747086 (Aug. 26, 1977) (loss on conversion of pesos which were invested in Mexican bank deposits may not offset interest income generated from such deposits). *But see Bowers v. KerbaughEmpire Co.*, 271 U.S. 170 (1926) (repayment of foreign currency borrowing held not to result in taxable gain or loss.); *Coverdale v. Comr.*, 4 T.C.M. 713 (1945); *B.F. Goodrich Co. v. Comr.*, 1 T.C. 1098 (1943), acq., 1943 C.B. 10, nonacq., 1974-2 C.B. 5 (original acquiescence withdrawn). There are two well recognized exceptions to the separate transaction principle: (i) a dealer in foreign exchange can use the lower of cost or value to determine foreign currency inventory (Rev. Rul. 75-104, 1975-1 C.B. 18), and (ii) a foreign branch of a U.S. taxpayer may translate unremitted foreign currency denominated profits into dollars at the exchange rate in effect at the end of a taxable year (under pre-Act law) or using the weighted average exchange rate (under the Act).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

respect of a U.S. dollar taxpayer's foreign currency-denominated purchase of inventory on credit, a separate exchange gain or loss attributable to any fluctuation in the U.S. dollar value of the foreign currency principal amount of the obligation between the date it was incurred and the date it is repaid must be recognized, rather than being incorporated into the basis of the purchased inventory. The "separate transaction" principle has been codified in §988(a)(1)(A), but (as discussed below) the legislative history of the Act suggests that Congress intended to modify its operation in respect of transactions covered under the Act.

2. Transactions Covered Under the Act

The Act rules apply to "§988 transactions," a defined term which includes any of the following types of transactions if such transactions are denominated in a nonfunctional currency or are determined by reference to the value of one or more nonfunctional currencies:

(i) Acquisition of or becoming the obligor under a debt instrument, which, to the extent provided in regulations, includes preferred stock;

(ii) Accruing (or otherwise taking into account for purposes of subtitle A of the Internal Revenue Code, relating to income taxes) any item of expense or gross income or receipt which is to be paid or received after the date in which so accrued or taken into account;

(iii) Entering into or acquiring any forward contract, futures contract, option or similar financial instrument (including a currency swap) if such instrument is *not* marked to market at the close of the taxable year under §1256; or

(iv) Disposition of a nonfunctional currency, which for purposes of this definition includes coin or currency and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank of other financial institution.[38]

As explained in the legislative history of the Act, the above reference to transactions which are "denominated" in a nonfunctional currency makes clear that a §988 transaction need not require or even permit repayment with a nonfunctional currency.[39] Rather, a §988 transaction includes any transaction determined by reference to the value of nonfunctional currency; thus, multi-currency contracts (*e.g.*, contracts pursuant to which a taxpayer can elect the desired currency of payment (or repayment)) are covered under the Act. Prior to the Act, some commentators suggested that certain adverse tax consequences associated with foreign currency gains and losses could be avoided by arranging to repay a foreign currency loan in U.S. dollars equivalent in value (at the time of repayment) to the borrowed currency.[40] The new provision would appear to foreclose any such opportunities.

As mentioned above and as can be readily determined by an examination of the definition of a §988 transaction, the rules of the Act do not apply to all types of transactions. First, §988(c)(1) provides that the Secretary may prescribe regulations excluding expenses or items of gross income from the definition of a §988 transaction if the inclusion of such items is "not necessary to carry out the purposes of this section by reason of the small amounts or short periods involved, or otherwise." The Senate Report provides as examples of such items receivables and payables that have a maturity of 120 days or less, and any other receivables or payables with a maturity of six months or less if such receivables or payables would be eligible for exclusion under §1274.[41]

The rules also do not apply to stock transactions (other than preferred stock to the extent provided in regulations), investments in plant, equipment or other fixed assets, or the cash purchase acquisition of inventory. In addition, the definition of a §988 transaction includes forward contracts, futures contracts, option contracts or other similar financial instruments only if such instruments are not marked to market for the taxable year. §988(c)(1)(B)(iii). Thus, the Act does not alter, for example, the §1256(a)(3) "60/40" treatment of capital gains and losses under the mark to market rules of §1256.

Finally, a §988 transaction includes a transaction entered into by an individual only if the expenses attributable to the transaction would be deductible under §162 or §212 and are not expenses incurred in connection with the determination, collection or refund of taxes.[42] The legislative history of the Act states that, for example, §988 would not apply to foreign currency gain or loss recognized by a U.S. individual residing outside the United States upon the repayment of a foreign currency denominated mortgage on the individual's principal residence.[43]

As to the above transactions which are not considered §988 transactions and thus are not covered under the Act, pre-Act law continues to apply.

3. General Consequences Associated with §988 Transactions

a. Timing and Amount of Exchange Gain or Loss

(1) Definition of Foreign Currency Gain or Loss

For purposes of §988, §988(b)(1) defines foreign currency gain as "any gain from a section 988 transaction to the extent such gain does not exceed gain realized by reason of changes in exchange rates on or after the booking date and before the payment date." Foreign currency loss is defined under §988(b)(2) to mean "any loss from a §988 transaction to the extent such loss does not exceed the loss

[38] §988 (c)(1)(B) and (c)(1)(C).

[39] Senate Report at 460.

[40] Committee on Foreign Activities of U.S. Taxpayers, Section of Taxation, American Bar Association, "Report on the U.S. Treasury Department Discussion Draft on Taxing Foreign Exchange Gains and Losses," 36 Tax L. Rev. 425, 441 (1981). For a contrary view, *see* Newman, "Tax Consequences of Foreign Currency Transactions: A look at Current Law and an Analysis of the Treasury Department Discussion Draft" 36 Tax Law. 223, 236 (1983); *see also American Air Filter Co. v. Comr.*, 81 T.C. 709 (1983) (where a loan agreement provided that a liability payable in foreign currency could be converted to one payable in another currency, the conversion to a U.S. dollar liability was treated as a realization event); GCM 39294 (June 15, 1984) (where the IRS noted that repayment in U.S. dollars instead of foreign currency does not alter the tax consequences).

[41] Senate Report at 460.

[42] §988(e).

[43] Conference Report at II-669.

realized by reason of changes in exchange rates on or after the booking date and before the payment date."[44] For the above purposes, "booking date" in the case of a §988(c)(1)(B)(i) transaction (*i.e.*, involving the acquisition of a debt instrument or becoming the obligor under a debt instrument) means the date of acquisition or the date on which the taxpayer becomes the obligor, respectively. Booking date as to a §988(c)(1)(B)(ii) transaction (*i.e.*, the accruing, or otherwise taking into account, of an item of expense or gross income or receipt to be paid or received after the date on which so accrued or taken into account) is the date on which such transaction is accrued or otherwise taken into account. The payment date for such a transaction is the date on which payment is made or received. §988(c)(2) and (3).

The booking date for §988(c)(1)(B)(iii) transactions (*i.e.*, entering into or acquiring a forward contract, futures contract, options contract or similar financial instrument) is the date on which the position is entered into or acquired, while the payment date in respect of such transactions is the date on which payment is made or received or the date on which the taxpayer's rights with respect to the position are terminated. Since the payment date in respect of such transactions includes only the date on which payment is made or received or the date on which the taxpayer's rights were terminated, §988 makes clear, for example, that it was anticipated that entering into an offsetting position would result in foreign currency gain or loss only if an actual closeout is effected at such time. If the offsetting position is simply an economic offset of an existing position, no foreign currency gain or loss exists for purposes of §988.

Finally, in respect of a §988 transaction involving the disposition of a nonfunctional currency, "acquisition date" is substituted for the booking date, and "disposition" is substituted for payment date in §988(b)(1) and (2).[45]

(2) Realization Events in Respect of §988 Transactions

As can be seen from the definition of exchange gain or loss, the above rules generally do not alter the existing law in regard to the requirement that a realization event is required before exchange gain or loss is taken into account for U.S. tax purposes.[46] In this regard, foreign currency gain or loss is defined under §988(b)(1) and (2) as "gain" or "loss" *to the extent* such gain or loss does not exceed the realized gain or loss attributable to movements in exchange rates. Thus, the statute appears to incorporate existing law realization principles because it requires gain or loss to be present and then defines such gain or loss as foreign currency gain or loss to the extent such gain or loss is attributable to movements in exchange rates. For example, a foreign currency borrowing must be repaid before exchange gain or loss is taken into account for U.S. tax purposes, and foreign currency itself (like other property) must be sold or otherwise disposed of in order for any appreciation or depreciation of the foreign currency to be taken into account for U.S. tax purposes.

The rules of the Act do, however, affect normal realization principles in two instances. The Act "clarifies" that the use of a nonfunctional currency to establish a demand or time deposit denominated in the same currency or the conversion of such a deposit to another deposit in the same currency is not a realization event. This is because the definition of a §988 transaction, which generally includes the disposition of a "nonfunctional currency," provides that a nonfunctional currency for such purposes includes not only the currency itself but also demand or time deposits or similar instruments issued by a bank or other financial institution.[47] One technical question which arises, however, is whether the establishing or converting of a time or demand deposit or similar instrument might be considered a realization event once excluded from the definition of a §988 transaction. In other words, since §988 does not alter the general principle that foreign currency is property, the determination of whether a realization event has occurred for U.S. tax purposes in respect of a non-§988 transaction arguably must be determined under general principles and, under such principles, a realization event may have occurred.

Section 988 also applies special rules for so-called §988 hedging transactions. As discussed in more detail at 4, g *infra*, §988(d) provides that all transactions which are part of §988 hedging transactions, if fully hedged, are, to the extent provided in regulations, to be integrated and treated as a single transaction. As explained in the Conference Report at II-666, the intended effect of such integration is to treat the predetermined future cost of the currency pursuant to the hedge (which cost is based on expected movements of the currency) as a current expense or income item in respect of the integrated transaction. Thus, for example, the premium reflected in the forward rate of forward purchase contracts used to fully hedge the principal amount of a borrowing in a strong currency (relative to the taxpayer's functional currency) is taken into account over the term of the borrowing notwithstanding that the forward contract will not be closed out (and thus the premium will not be paid) until the maturity of the borrowing. (*See* Example in 4, g, (2) *infra*.) Under normal realization principles, a gain or loss would not arise until the contract is actually terminated (*e.g.*, by sale or offset) or, if the closeout is effected by delivery, the time at which the acquired currency is transferred. The rules under §988 therefore alter pre-Act realization principles in respect of §988 hedging transactions.

By contrast, the final Treasury proposal would have required that taxpayers accrue currently anticipated exchange gains or losses as to both financial hedging transactions *and* nonhedging transactions.[48] Under such an anticipated exchange gain or loss approach, the taxpayer would have been required to use an objective index (*i.e.*, the applicable federal rate) in order to determine the expected value of the currency during the term of a nonhedging

[44] The Conference Report states, at II-663, that foreign currency denominated items are to be translated into U.S. dollars using the exchange rate that most properly reflects income and that generally such exchange rate will be the free market rate.

[45] §988(c)(1)(C)(i)(II).

[46] Conference Report at II-663.

[47] §988(c)(1)(C)(ii).

[48] U.S. Treasury, *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity* 417-418 (May 1985).

transaction. Such expected value would have been required to be accounted for currently as an adjustment to interest expense or interest income associated with the transaction, with any "unexpected" movement in the exchange rates being accounted for as unanticipated exchange gain or loss at the time of a realization event under normal principles.

The theory behind anticipating exchange gain or loss in respect of financial transactions is that the difference between the interest rates in the various currencies is attributable to expected exchange gains or losses which will offset such interest differential. Thus, a taxpayer which borrows a strong currency (*e.g.*, the Swiss franc) at a 5% interest rate at a time when U.S. interest rates are 9% expects an exchange loss which will approximately offset the 4% differential between the cost of U.S. dollars and the cost of Swiss francs. The problems with such an approach, and apparently the reasons the approach was not adopted by Congress in the Act are (i) an anticipated gain or loss based on an external index does not reflect other factors which may determine the differential in respect of a particular taxpayer's transactions (*e.g.*, industry projections, the particular taxpayer's market share or credit standing), and (ii) such an approach is extremely difficult to apply and administer as a practical matter.[49]

(3) Separate Transaction Principle

As discussed above, the separate transaction principle generally has been incorporated into §988(a)(1)(A), which provides that foreign currency gain or loss attributable to a §988 transaction shall be computed "separately." The Conference Report, however, provides that "foreign currency gain or loss is recognized only to the extent of the total gain or loss, taking into account gain or loss on the underlying transaction." [50]

Under the Conference Report examples (at II-664), the significance of this language seems to be that where there is a gain or loss on the underlying transaction, as well as offsetting foreign currency loss or gain, the two should be "*netted*" and only the excess amount of *foreign currency* loss or gain, if any, should be reported "separately" under §988(a)(1)(A). The example in the Conference Report used to illustrate this point is as follows: If a taxpayer whose functional currency is the U.S. dollar acquires a debt obligation that is not part of a §988 hedging transaction for 100 pounds when the exchange rate is 1 pound = $1 and sells the obligation for 200 pounds when the exchange rate is 1 pound = $2, $100 of the taxpayer's $300 gain ($400 sales price less $100 basis) is foreign currency gain attributable to difference between U.S. dollar value of sterling principal at date of acquisition ($100) and date of sale ($200). This is calculated by multiplying the difference in exchange rates between the booking date (1 pound = $1) and the payment date (1 pound = $2) by the units of functional currency originally booked by the taxpayer (100 pounds) . . . . In the above example, if the exchange rate had fallen to 1 pound = $.5, the taxpayer would have had no foreign currency (or nonforeign currency) gain or loss; if the exchange rate had fallen to 1 pound = $.75, the taxpayer would have had a $50 nonforeign currency gain; if the exchange rate had fallen to 1 pound = $.25, the taxpayer would have had a $50 foreign currency loss.

As modified, the "separate transaction" principle seems to be limited to requiring that exchange gain or loss not be characterized entirely as gain or loss from the underlying transaction in all cases. To the extent that there is inconsistent movement in the intrinsic and currency values in respect of the underlying transaction, however, the foreign currency gain or loss is not considered separate from the gain or loss in respect of the underlying transaction for purposes of §988. Such treatment is difficult to justify considering that the gain or loss in respect of the underlying transaction in many instances (if not most instances) would have virtually no relationship with the movement of exchange rates, and the consequences regarding, for example, the source and character of the total gain or loss in respect of a particular transaction (and possibly the amount of Subpart F income from a particular transaction) could be altered rather dramatically because of such treatment.[51]

b. Character of Section 988 Transaction Exchange Gain or Loss

Section 988(a)(1)(A) provides that foreign currency gain or loss in respect of §988 transactions is to be treated as ordinary income or loss.[52] Under prior law, the character of exchange gain or loss was, as a general proposition, determined by reference to the character of the gain or loss in respect of the underlying transaction,[53] or to the character of the currency itself in the case of a disposition of currency. Thus, unless the property was determined to fall within one of the exceptions enumerated in §1221 or within an established judicial exception, the gain or loss would be considered capital gain or loss. In many cases, the result was to ignore the factors which created the exchange gain or loss (*e.g.*, interest rate differentials) and simply to characterize the gain as capital because the gain or loss from the underlying transaction was capital gain or loss.

The Act apparently has, however, continued prior law in respect of certain hedging transactions. Under prior law, the principal judicial exception for purposes of determining the character of exchange gains and losses evolved through a series of early cases and IRS rulings principally involving commodity hedging transactions,[54] and which ultimately culminated in *Corn Products Refining Co. v. Comr.*, 340

[49] Senate Report at 452-453; House Report at 466-467.

[50] Conference Report at II-663-664.

[51] In addition, the modified separate transaction principle could have an effect on provisions applied by reference to the gross amount of a taxpayer's income (*e.g.*, "80-20" status).

[52] The capital gain or loss distinction will continue to have relevance for taxpayers under the new law until the first taxable year in which the taxpayer is subject to the 34% (corporations) or 28% (individuals) rate, and also for purposes of determining the deductibility of capital losses.

[53] *American-Southeast Asia Co. v. Comr.*, fn. 37 *supra* at 201; *Church's English Shoes, Ltd. v. Comr.*, 24 T.C. 56 (1955), aff'd *per curiam*, 229 F.2d 957 (2d Cir. 1956); Rev. Rul. 78-281, 1978-2 C.B. 204, where a "look through" analysis was applied to characterize gains from the discharge of foreign currency borrowing entered into pursuant to a financed purchase of equipment.

[54] *See, e.g., Trenton Cotton Oil Co. v. Comr.*, 147 F.2d 33 (6th Cir. 1945); *Commissioner v. Farmers & Ginners Cotton Oil Co.*, 120 F.2d 772 (5th Cir. 1941), cert. denied, 314 U.S. 683 (1941); *Battelle v. Comr.*, 47 B.T.A. 117 (1942); *Grote v. Comr.*, 41 B.T.A. 247 (1940); GCM 17322, XV-2 C.B. 151 (1934).

U.S. 46 (1955). In that case, the taxpayer, engaged in the production of distilled products from corn, purchased corn futures to protect itself against future price increases in the raw corn needed in its manufacturing operations. In holding that the gains realized on the closeouts of the futures contracts constituted ordinary income, the Court noted that the futures transactions "were vitally important to the company's business," and that "Congress intended that profits and losses arising from everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss." [55]

In applying the *Corn Products* doctrine to foreign currency hedging transactions, the authorities generally have required that the exchange gain or loss in respect of the hedging transaction be determined by reference to the character of the gain or loss of the hedged item.[56] As discussed below in more detail, the rules for §988 hedging transactions provide that, where appropriate, the character (and source) of exchange gain or loss in respect of a "partial hedge" be consistent with the character of exchange gain or loss on the hedged item.[57]

The general characterization of exchange gain or loss as ordinary in character followed the Senate approach, while the House would have treated such gain or loss as interest income or interest expense for all purposes of the Code except §§871(a), 881, 1441, 1442 and 6049. H.R. 3838, §661(a). The Senate Report states that such an approach offers a "pragmatic solution" to an issue with respect to which "tax scholars and practitioners" could not agree.[58] (The primary reasons for rejecting an interest characterization for exchange gains and losses are basically the same as the reasons (discussed above) for rejecting the notion of anticipated gain or loss.)

One possible criticism of such an approach is that exchange gain or loss does not necessarily reflect only movements in interest rates. Even if one adopts the position that exchange gain or loss should be the equivalent of interest (*i.e.*, ordinary income or expense) to the extent such gains or losses reflect differences in interest rates as to different currencies, the treatment of §988 exchange gains and losses as entirely ordinary income or loss will distort the character of the income or loss from a transaction to the extent the exchange gain or loss does not reflect interest rate differentials (*i.e.*, the so-called unanticipated exchange gain or loss under the Treasury Department's proposal). Moreover, as at least one commentator has already pointed out, since §988 applies to only a limited universe of transactions, gains or losses in respect of transactions which fall outside of §988 (*e.g.*, futures contracts governed by §1256) may reflect the same movement of exchange rates as gains or losses in respect of transactions which fall within §988 (*e.g.*, foreign currency denominated bonds), but the character of the income or loss could well be capital in the former situation but ordinary in the latter.[59]

In some instances, the disparate character treatment of similar transactions which fall within and without §988 is eliminated under §988(a)(1)(B), which provides the taxpayer with an election to treat any foreign currency gain or loss attributable to a forward contract, futures contract, or option contract which falls within §988 (*i.e.*, a contract which is *not* marked to market under §1256) as capital gain or loss if the contract is not part of a straddle as defined under §1092(c) (without regard to the exception therein for qualified covered calls and optioned stock). The taxpayer must make the election and identify the transaction before the close of the day on which such transaction is entered into (or such earlier time as the Secretary may prescribe). Thus, in respect of such transactions, the taxpayer may elect to receive consistent character treatment of any exchange gain or loss for functionally similar transactions which for technical or other reasons fall within and without §988.

c. *Interest Income or Interest Expense Characterization*

Although the Act did not adopt the House approach regarding a general interest income or expense characterization for foreign currency gains and losses, respectively, §988(a)(2) provides that, to the extent provided in regulations, amounts treated as ordinary income or loss under the above rules are to be treated as interest income or interest expense, as the case may be. The Conference Report states that the regulations may apply such treatment for selected purposes only.[60] (As discussed above, the House Bill would have treated foreign currency gain or loss as interest income or interest expense for all purposes of the Code except for purposes of taxing nonresident aliens or foreign corporations (*i.e.*, §§871, 881, 1441 and 1442) and for purposes of the information reporting provisions (*i.e.*, §6049)).

Since foreign currency gain generally is not income of the type subject to taxation on a gross basis (*i.e.*, fixed or determinable annual or periodical income), presumably such gain will not be treated by regulation as interest income for purposes of the taxation of nonresident aliens or foreign corporations (*i.e.*, §§871, 881, 1441, and 1442). However, where payments have been fixed based on expected movements in exchange rates and thus the overall "exchange" gain or loss associated with the transaction has been predetermined, characterization as interest income (or interest expense) may well be appropriate. In this regard, the Senate Report states that an example of an appropriate circumstance in which foreign currency gain or loss should

[55] 340 U.S. at 50, 52.

[56] *Wool Distributing Corp. v. Comr.*, 34 T.C. 323 (1960), gain realized on a foreign wool dealer's closeout of a foreign currency forward sale contract entered into to protect against currency devaluation and resulting reduction in the market price of wool was held ordinary because the asset being hedged (the wool inventory) was an ordinary business asset in the taxpayer's hands; *Hoover Co. v. Comr.*, 72 T.C. 206 (1979), nonacq., 1980-1 C.B. 2, and *International Flavors and Fragrances Inc. v. Comr.*, 62 T.C. 232 (1974), rev'd and rem'd, 524 F.2d 357 (2d Cir. 1975); 36 T.C.M. 260 (1977) (decision on remand), in which gains realized by U.S. parent corporations on their closeout of foreign currency forward contracts entered into to offset the financial statement (FASB 8) exposure in respect of their foreign subsidiaries were held to be capital gains because the asset being hedged (the parents' stock investment in their subsidiaries) was a capital asset in the taxpayers' hands.

[57] Conference Report at II-666-667.

[58] Senate Report at 452.

[59] O'Neill and Lee, "Federal Income Tax Treatment of Foreign Currency Transactions After the Tax Reform Act of 1986," Tax Notes 185 to 189 (Special Report, October 13, 1986).

[60] Conference Report at II-665.

be treated as interest income or expense, respectively, is in the case of hedging transactions where a taxpayer's expectations about future exchange rates are reflected at the outset in the overall costs of the transaction.[61] In addition, the Conference Report states that the Secretary will address the appropriate treatment of payments made to a counterparty under a swap transaction for purposes of the withholding tax provisions (*i.e.*, §§871 and 881).[62]

d. Source of §988 Transactions Exchange Gain or Loss

(1) Prior Law

The source of exchange gain and the allocation and apportionment of exchange loss was perhaps the most unsettled issue regarding foreign currency transactions under pre-Act law. For example, as to the disposition of foreign currency itself, the applicable rule technically would be the "title passage" test in regard to foreign currency gain.[63] Obvious difficulties arise in determining the location of the passage of "title" in regard to "property" which is used as a medium of exchange such as foreign currency. In addition, special re-sourcing rules applicable to dispositions of personal property could well have applied in determining the source of exchange gain or loss in respect of a disposition of currency.[64]

Similarly, the allocation and apportionment of losses from a disposition of currency generally required a strained analysis of existing rules regarding property dispositions. Regs. §1.861-8(e)(7) provides that losses from the disposition of capital or §1231(b) assets "shall be allocated directly to the class of gross income to which the property (*i.e.*, the foreign currency) ordinarily gives rise in the hands of the taxpayer." Again, because foreign currency typically is used as a medium of exchange, it does not "ordinarily" give rise to any particular class of gross income in the hands of U.S. taxpayers. Assuming the absence of a class of income to which the losses could be directly related, an argument might be made that the class of income generated by the activities for which the currency was used should be the income to which the currency ordinarily gives rise (*i.e.*, a "look through" approach). However, there was no authority which supported such an approach even in the context of fully hedged transactions, where tracing would appear to be the most logical solution.[65] Moreover, since the rules for losses (as with gains) required a determination of the status of the currency as a capital or §1231(b) asset, the above rules in effect incorporated the additional uncertainty (discussed above) under pre-Act law regarding the determination of the character of exchange gain or loss.

If the losses were not definitely related to any class of gross income, under pre-Act law the taxpayer would have been required to allocate the losses to all classes of gross income and apportion the losses between foreign and U.S. sources in accordance with the ratios of foreign and U.S. source gross income, respectively, to worldwide gross income.[66] Such an allocation would be virtually identical to the pre-Act "gross income" method for allocating interest expense [67] and probably would be more consistent with the nature of the loss than the approach of Regs. §1.861-8(e)(7). Indeed, such an approach generally would have been consistent with the approach taken under the House Bill, which would have allocated and apportioned exchange losses (and exchange gains) in the same manner as interest expense (and interest income).

(2) Act Rules

Under the Act, exchange gains and losses treated as ordinary income or loss under §988 are, except as otherwise provided in regulations, to be sourced by reference to the residence of the taxpayer (or the QBU of the taxpayer) on whose books the asset, liability or item of income or expense giving rise to such gain or loss is properly reflected.[68] (For this purpose, the election under §988(a)(1)(B) to treat exchange gains or losses as capital gains or losses is disregarded.[69]) Residence in the case of an individual is his or her tax home and in the case of a corporation, partnership, trust or estate which is (i) a U.S. person, the United States or (ii) a non-U.S. person, a country other than the United States. The residence of a QBU (including a QBU of an individual) is the country in which the principal place of business of such QBU is located.[70]

Sourcing exchange gain or loss in accordance with the taxpayer's residence is consistent with the treatment of foreign currency as property and the general amendments to the sourcing rules in regard to other types of property (except inventory) under §1211 of the Act. The Senate Report, at 453, states that sourcing exchange gains or losses in accordance with residence will "tend to neutralize the effect of exchange gain or loss on the calculation of foreign tax credits (unlike present law, under which wide swings in exchange rates can result in unpredictable reductions in net foreign source income.)" It is not clear, however, that such treatment will "neutralize" the effect of exchange gains or losses on the calculation of the foreign tax credit unless the taxpayer has offsetting gains and losses, whether as a result of a particular transaction (*i.e.*, hedged transactions) or on an overall basis. (As discussed at g *infra*, consistent treatment of the sourcing of exchange gains and losses in respect of certain hedging transaction is required under the Act.)

[61] Senate Report at 452.
[62] Conference Report at II-668.
[63] Regs. §1.861-7.
[64] Pre-Act §904(b)(3)(C). Section 904(b)(3)(C) was designed to limit abuse of the "title passage" rule (*i.e.*, the making of sales aboard solely to generate foreign source gains and thereby increase the foreign tax credit limitation), and re-sources foreign source gains attributable to the "sale or exchange" of a capital asset as U.S. source gains unless (i) personal property is sold by an individual inside the country where the individual was resident; (ii) in the case of any taxpayer, the property was sold in a country in which the taxpayer derived more than 50% of its gross income for the 3-year period preceding the sale; (iii) a foreign tax of 10% or more was paid on the sale or exchange; or (iv) a corporation sells shares in a second corporation in the country in which the second corporation is resident, and the second corporation derived more than 50% of its gross income from that country during the preceding 3-year period.
[65] *See* the discussion at g (3) *infra* regarding sourcing of exchange gain or loss in respect of certain partial hedges.
[66] Regs. §1.861-8(b)(5); Regs. §1.861-8(c)(2).
[67] Regs. §1.861-8(e)(2)(vi).
[68] §988(a)(3)(A).
[69] §988(a)(3)(A).
[70] §988(a)(3)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(3) Resourcing Rule for Related Party Transactions

Section 988(a)(3)(C) provides a special "resourcing" rule in regard to certain loans by a United States person or a related party to a 10%-owned foreign corporation. The "resourcing" rule requires that affected loans be marked to market on an annual basis and interest income earned on the loan during each respective year be treated as U.S. source income for §904 purposes to the extent a loss is determined to exist by virtue of such treatment. As explained in the Senate Report, the "resourcing" rule was included because of concern that the general rule that looks to residence could be manipulated to artificially increase foreign source income for purposes of computing allowable foreign tax credits.[71]

Loans with respect to which such treatment is required are loans by a U.S. person or a related person (*e.g.*, a foreign subsidiary) to a 10%-owned foreign corporation, which loan is denominated in a foreign currency and bears interest at a rate at least 10 percentage points higher than the applicable federal rate (at the time the loan was entered into) for mid-term obligations. For the purposes of this special "resourcing rule," "related person" has the meaning given such term by §954(d)(3) except that "United States person" is substituted for "controlled foreign corporation" in §954(d)(3) wherever such term appears.[72] The term 10%-owned foreign corporation means any foreign corporation in which the United States person owns directly or indirectly at least 10% of the voting stock.[73]

The Conference Report, at II-668, states that the Secretary is provided regulatory authority to apply rules similar to the rules for related party loans "to loans to U.S. persons." The regulatory authority apparently is granted pursuant to §989(c)(5), which provides regulatory authority for the appropriate treatment of "related party transactions." The situations in which such authority is to be used, however, are not clear. One situation may be in respect of loans to "80-20" corporations, which may generate foreign source interest income that is expected to be offset by an exchange loss. Under the Act, the offsetting interest expense within the consolidated group would be allocated on the basis of consolidated group assets and thus such interest expense may not entirely offset the interest income earned by the shareholder or related party.

4. Consequences of Selected §988 Transactions

a. Currency Transactions

As discussed above, §988 did not affect the present law principle that foreign currency is treated as property with respect to which the taxpayer establishes a basis, with gain or loss upon a "sale or other disposition" of the foreign currency being realized under §1001 in the amount by which such basis differs from the proceeds of such sale or other disposition.[74] Such sales or other dispositions of the currency may occur in connection with other transactions (*e.g.*, borrowing or lending) or simply result from the sale of the currency in exchange for the taxpayer's functional currency.

Assume, for example, that a U.S. parent corporation with the U.S. dollar as its functional currency acquired 165,000,000 Swiss francs at a cost of U.S. $100,000,000, and loaned the Swiss francs to its Swiss subsidiary in exchange for a two year note after holding the Swiss francs for 30 days. Assume further that the 165,000,000 Swiss francs were worth U.S. $98,000,000 at the time the loan to the Swiss subsidiary was made and were worth U.S. $110,000,000 at the time the loan was repaid. Finally, assume that the parent held the Swiss francs repaid by the subsidiary for 15 days prior to converting the currency into U.S. $107,000,000.

Three taxable events occurred in the above example, two of which were a result of the disposition of the currency itself. The first taxable event occurred at the time the Swiss francs were loaned to the subsidiary, because (as property) the foreign currency was deemed to have been "sold" for the subsidiary's note. The parent realized an exchange loss of U.S. $2,000,000 in respect of such sale, the difference between its basis in the loaned Swiss francs (U.S. $100,000,000) and the U.S. dollar proceeds from its sale (U.S. $98,000,000). As discussed in more detail below, the parent realized a U.S. $12,000,000 exchange gain on the repayment of the loan by the subsidiary, which is equal to the difference between the U.S. dollar value of the Swiss francs at the time the loan was made (U.S. $98,000,000) and the U.S. dollar value of the Swiss francs upon repayment of the subsidiary loan (U.S. $110,000,000). Finally, the parent realized a loss at the time it converted the Swiss francs into U.S. dollars. The amount of such loss was U.S. $3,000,000, the difference between the U.S. $110,000,00 basis in the Swiss francs which the parent acquired at the time the subsidiary loan was repaid and the U.S. $107,000,000 realized on its conversion of the Swiss francs into U.S. dollars.

Although the above analysis is the same as under pre-Act law [75] (as discussed above), §988 provides new rules in regard to the character and source of the exchange gain and loss resulting from the transaction. The character of the losses in regard to the "sales" of Swiss francs would be ordinary under §988(a)(1)(A) and the losses (assuming the parent was not operating through a QBU) would be allocated and apportioned entirely to U.S. source income.[76] Similarly, as discussed below, the parent's gain in respect of the repayment of the loan would be ordinary and U.S. source.

Under pre-Act law, the gains and losses would be capital in character unless a statutory exception under §1221 or (more likely) a judicially created exception to capital gain or loss treatment such as *Corn Products* applied. The source of the exchange losses attributable to dispositions of the Swiss franc likely would be determined under the strained application (discussed above) of the source provisions in respect of property transactions (or,

[71] Senate Report at 468.

[72] §988(a)(3)(C) (flush language).

[73] §988(a)(3)(D).

[74] The Act, adding §988(b) to the Code, provides that foreign currency gain or foreign currency loss will exist for §988 purposes to the extent the gain or loss realized on a currency disposition is attributable to movements in exchange rates between the acquisition date (*i.e.*, the booking date in respect of such a transaction) and the date of disposition (*i.e.*, the payment date in respect of such a transaction).

[75] *See KVP Sutherland Paper Co. v. U.S.*, fn. 37 *supra*.

[76] §988(a)(3). It is also assumed that the special resourcing rule of §988(a)(3)(C) does not apply.

alternatively on a gross income apportionment basis). The source of the exchange gain in respect of the repayment of the loan would be determined under the "title passage" rule, unless the special resourcing rule under former §904(b)(3)(C) applied.[77]

b. Accounts Payable and Accounts Receivable

If a taxpayer agrees to be paid or agrees to pay a nonfunctional currency for the sale of goods or performance of services, it will take into account exchange gain or loss under the Act equal to the difference between the functional currency value of the receivable or payable on the date it arose and the date it is paid, respectively.[78] Under pre-Act law, the character of any exchange gain or loss attributable to the fluctuation in the U.S. dollar value of the payable or receivable itself, any such gain or loss attributable to the currency used to repay the borrowing, and any such gain or loss attributable to any obligation incurred to finance the acquisition of any underlying property was ordinary in character.[79]

The source of any exchange gain or loss in respect of accounts payable or accounts receivable usually was determined by reference to the source of the underlying transaction (*e.g.*, an exchange gain in respect of accounts payable resulting from the performance of services was sourced by reference to the place where the services were performed). The Senate and House Reports raise a question, however, whether under pre-Act law the separate transaction principle would have required that the exchange gain or loss in respect of such transactions be sourced separately from the underlying transaction.[80]

The character of exchange gain or loss in respect of accounts payable or accounts receivable under the Act is (as under pre-Act law) ordinary in character.[81] As discussed above, any such exchange gain or loss would be sourced by reference to the taxpayer's residence which, in the case of a QBU, is the country in which the principal place of business of the QBU is located.[82]

c. Foreign Currency Debt Instruments

(1) General Rules Applicable to Foreign Currency Debt Instruments

(a) Amount of Exchange Gain or Loss in Respect of Debt Instruments

As discussed above, the amount of foreign currency gain or loss required to be taken into account under §988 on the repayment of debt instruments is equal to the gain or loss on such repayment to the extent that such gain or loss does not exceed gain or loss *realized* by reason of changes in exchange rates on or after the booking date and before the payment date. (For §988 purposes, "debt instrument" means a bond, debenture, note, certificate or other evidence of indebtedness. In addition, to the extent provided in regulations, such term also will include preferred stock.)[83] Thus, the amount of exchange gain or loss realized in respect of such repayment must first be determined under general principles, and then such gain or loss must be characterized as gain or loss for §988 purposes to the extent attributable to the movement in exchange rates between the relevant dates.

One problem with such an approach is that the amount of exchange gain or loss realized under "normal" principles in respect of the repayment of a foreign currency obligation is unsettled. One approach (which has been adopted by the IRS in TAM 8435006 and accompanying GCM 39294) is to compute the amount of such gain or loss by subtracting the basis of the currency used to repay the borrowing from the U.S. dollar value of the foreign currency at the time borrowed. Under this approach (hereinafter referred to as the "single-step" approach), the amount realized with respect to the currency used to repay the borrowing is the U.S. dollar value of the foreign currency at the time borrowed, and thus the fair market value of such currency at the time the borrowing is repaid is irrelevant in determining the amount of gain or loss realized on such repayment.

The courts and the IRS clearly have applied the "single step" approach in the context of nonrecourse borrowings. The most prominent authority in the context of nonrecourse borrowings is the *Tufts*[84] decision, in which the Supreme Court held that the amount realized with respect to property used to extinguish a nonrecourse U.S. dollar liability is the face amount of such borrowing, notwithstanding that the fair market value of the property was admittedly less than such face amount. In this regard, some commentators believe that the amount realized with respect to the repaid currency on the repayment of a foreign currency borrowing should be the same as the "amount realized" with respect to property which extinguishes a nonrecourse liability, since as to both types of borrowings the parties have agreed at the time the borrowing is entered into that an amount of property, whatever its value, will be deemed sufficient to extinguish the debt at maturity.[85] It is not clear, however,

[77] As discussed above, a §988 transaction does not include the establishing of a demand deposit, time deposit or similar instrument issued by a bank or other financial institution or the conversion of such instruments into other such instruments denominated in the same currency. As a result, unless (as discussed above) the taxpayer is considered to have disposed of the currency outside the context of §988, the taxpayer will not realize any exchange gain or loss in respect of such currency transactions.

[78] *See Bennett's Travel Bureau, Inc., v. Comr.*, 29 T.C. 198 (1956) (where the taxpayer accrued a deduction for accounts payable in Norwegian kroner but, in a later year, settled the account at less than the U.S. dollar amount it had deducted); *Foundation Co. v. Comr.*, 14 T.C. 1333 (1950) (where the taxpayer performed service in Peru and accrued Peruvian soles, and the currency's value at the time of payment was lower than when the income was accrued).

[79] See *American-Southeast Asia Co. v. Comr.*, footnote 37 *supra* at 201 (1956); *Church's English Shoes, Ltd. v. Comr.*, footnote 53 *supra* (where the taxpayer imported goods on credit, the purchase of foreign currency to settle the account payable was viewed as part of the taxpayer's ordinary business, and, thus, an exchange gain was taxable as ordinary income). *See also* Code §1221(4) (an account receivable acquired for services rendered or sales of property in the ordinary course of business is excluded from the definition of a capital asset).

[80] Senate Report at 437; House Report at 453.

[81] §988(a)(1)(A).

[82] §988(a)(3).

[83] §988(c)(4).

[84] *Tufts v. U.S.*, 461 U.S. 300 (1983).

[85] O'Neill and Lee, Federal Income Tax Treatment of Foreign Currency Denominated Debt, 12 Int'l Tax J. (Winter 1986).

that the analysis in the nonrecourse authorities such as *Tufts*, which appears to accord significant weight to the fact that the face amount of the debt was included in the basis of the property so transferred (*i.e.*, a "tax benefit" analysis), applies generally to the repayment of a foreign currency borrowing.

Further, in the context of recourse liabilities, there is no clear authority which addresses the situation where the fair market value of the property used to repay the borrowing was admittedly less than the face amount of the retired debt.[86] Finally, it should be noted that the "single step" analysis would seem to be inconsistent with *Kentucky and Indiana Terminal Railroad v. U.S.*,[87] in which the Sixth Circuit held that gain on the repayment of a foreign currency borrowing is attributable to the borrowing itself (rather than the property (*i.e.*, the foreign currency) used to repay the borrowing) and thus such gain qualified as "cancellation of indebtedness" income.

An alternative approach is to determine the amount realized with respect to the currency used to repay the debt by reference to its fair market value, which is the same as the U.S. dollar value of the borrowing at its maturity. Under this approach, gain or loss attributable to the borrowing itself is also realized, and is computed by reference to the difference in the U.S. dollar value of the borrowing at the time borrowed and the U.S. dollar value of the borrowing at its maturity date.

Such an approach in effect bifurcates the gain or loss on the repayment of a foreign currency borrowing into two elements: (i) gain or loss attributable to the currency (*i.e.*, the property) used to repay the borrowing (computed by reference to the difference between the basis and fair market value of the currency so used) and (ii) gain or loss attributable to the borrowing itself (computed by reference to the difference in the U.S. dollar value of the borrowing at the time of the borrowing and at its maturity date).

As compared with the "single-step" approach, the bifurcation analysis arguably reflects the economic realities of the transaction because it accounts for the fair market value of the currency used to repay the borrowing, rather than simply attributing to such currency the initial U.S. dollar value of the borrowing. By taking into account the fair market value of the currency so used, the bifurcation approach in turn reflects the fact that the principal amount of the foreign currency borrowing itself has "fluctuated" in U.S. dollar terms. This should be contrasted with the analysis of a U.S. dollar borrowing for U.S. tax purposes, the value of which is not considered to fluctuate.

Such an approach would also appear to reflect the analysis of the Tax Court in *National Standard Co. v. Comr.*,[88] In *National Standard*, the IRS argued before the Tax Court that the amount of the loss on the repayment of the foreign currency borrowing, which was argued to be capital, should be computed by "calculating the amount realized as the U.S. dollar value of the francs at the time borrowed, less the adjusted basis calculated as the U.S. dollar value of the francs at the time the respective debts were repaid." [89] The majority of the Tax Court disagreed and stated that "the amount petitioner realized was not the U.S. francs when borrowed. Rather, it was the extinguishment of a debt at a time that debt had a U.S. dollar value equal to the cost of the francs used to pay off the debt." [90] The Tax Court also noted that the determination of the amount realized with respect to the currency used to repay the borrowing was inconsistent with the fact that the taxpayer had acquired the currency immediately prior to the loan repayment, and thus "the loss did not result from the transfer of depreciated property in satisfaction of a debt." [91] Finally, the Tax Court majority stated that the loss on the repayment of the borrowing "was due to the fact that the amount of the debt itself had increased in terms of U.S. dollars." [92]

Under the above analysis, it seems relatively clear that at least in the Tax Court's opinion a taxpayer would realize a separate exchange gain or loss with respect to the foreign currency borrowing itself to the extent that a difference exists between the U.S. dollar value of the currency at the time borrowed and the U.S. dollar value of the currency at the maturity of the borrowing. Further, although the facts of *National Standard* did not present the issue, it would seem to necessarily follow from the Tax Court's rationale that the borrower would have a separate gain or loss with respect to the currency used to repay the borrowing if (and only if) there is a difference between the basis of such currency and the U.S. dollar value of the borrowing at its maturity.[93]

The bifurcation approach would also seem to be consistent with the analysis of the Tax Court in *Danenburg v. Comr.*[94] *Danenburg* involved a taxpayer who had incurred bank debt with respect to the financing of real estate, farm equipment and the harvesting of crops. The taxpayer collateralized the loans with various properties, including all the stock owned by the taxpayer in a cattle company. The taxpayer failed to pay the loans and the bank exercised its right to the collateral. Except for the stock of the cattle company, all the property was sold by the taxpayer and the proceeds forwarded to the bank in order to reduce the outstanding debt. The cattle company stock was transferred to the bank in kind.

The Commissioner argued that the entire remaining amount of the original borrowing (after being reduced to the extent of the cash proceeds from the sales of the other collateral) was realized by the taxpayer in exchange for the stock. The Tax Court, however, found that the fair market value of the stock represented only a small fraction of the remaining amount of the original borrowing, and held that the lesser fair market value of the stock was the amount of the original borrowing realized with respect to the stock

[86] *See, e.g., Peninsula Properties Co. v. Comr.*, 47 B.T.A. 84 (1942), acq. 1942-2 C.B. 141; *Est. of Whitthorne v. Comr.*, 44 B.T.A. 1234 (1941), aff'd *per curiam*, 148 F.2d 825 (9th Cir. 1944); *Fifth Ave.-Fourteenth St. Corp. v. Comr.*, 147 F.2d 453 (2d Cir. 1944).

[87] 330 F.2d 520 (6th Cir. 1964).

[88] 749 F.2d 369 (6th Cir. 1984), aff'g 80 T.C. 551 (1983).

[89] 80 T.C. at 563, n.12.

[90] *Id.*

[91] *Id.* at 563.

[92] *Id.* at 569.

[93] It should be noted that, on appeal, the Sixth Circuit did not address the "amount realized" with respect to the currency used to repay the borrowing.

[94] 73 T.C. 370 (1979).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

transferred. Further, the Tax Court held that the amount of the remaining debt in excess of the fair market value of the stock was cancellation of indebtedness income. (In this regard, *see* Regs. §1.1017-1(b)(5), which provides that a taxpayer realizes cancellation of indebtedness income to the extent the fair market value of property transferred to retire debt is exceeded by the adjusted issue price of the debt.)

Considering that §988 measures foreign currency gain or loss in respect of a debt obligation by reference to the movement in exchange rates between the date on which the taxpayer becomes the obligor (*i.e.*, the booking date) and the date on which payment is made (*i.e.*, the payment date),[95] the "bifurcation" approach would appear to be more consistent with the general approach of that section. On the other hand, considering the modifications to the separate transaction principle discussed earlier, any exchange gain or loss in respect of the currency in any event may have to be netted with the exchange loss or gain in respect of the debt instrument itself, thereby in effect adopting the "single-step" approach.

Since (as discussed above) both the character in respect of any exchange gain or loss attributable to the debt instrument and any exchange loss or gain in respect of the currency itself would be ordinary under §988, the potential difference in the character of such gains and losses under pre-Act law is not continued under §988. By contrast, the difference in gross amounts of foreign and U.S. source gains and losses may well have an effect on the computation of the foreign tax credit limitation. As a result, there may be significant foreign tax credit consequences attached to whether the single step or bifurcation analysis is adopted by a taxpayer for purposes of §988 (or, if the bifurcation analysis is applied in the first instance, whether the gains and losses in respect of the currency and the borrowing are netted under the modified separate transaction principle). In addition, the choice of the proper analysis to be applied may well have an impact on limitations (or other provisions) under the Code which are implemented by reference to the amount of a taxpayer's gross income.[96]

At least until further clarification is provided regarding the intended application of §988, the above issues will remain unsettled.

(b) Timing of Exchange Gain or Loss in Respect of Debt Instruments

As discussed above, §988 does not alter the general principle under U.S. tax law that a realization event is required in order for exchange gain or loss to be taken into account for U.S. tax purposes. The realization event in respect of a foreign currency debt instrument is its repayment (either actual or constructive).[97] Subject to certain statutory and judicial exceptions (discussed below), a U.S. taxpayer also *recognizes* an exchange gain or loss attributable to a debt instrument for U.S. tax purposes at the time the debt instrument was paid.

Under pre-Act law, it was possible for taxpayers to defer exchange gain attributable to the repayment of a foreign currency borrowing by electing to reduce the basis of its depreciable assets in an amount equal to the gain (§§108 and 1017). (By making such election, the gain would be included in income over the average life of the depreciable assets on which bases had been reduced.) This result was supported by the Sixth Circuit's decision in *Kentucky and Indiana Terminal Railroad Co.*,[98] which characterized such gain as cancellation of indebtedness income. Since there was no corresponding deferral in respect of exchange losses, taxpayers could have deferred exchange gains in respect of foreign currency borrowings while receiving a current deduction for exchange losses. (*See* discussion below, however, regarding the possible deferral of such losses under §1092).

It is clear from the Senate and House Report that exchange gain from a foreign currency borrowing is not considered cancellation of indebtedness income under the Act and thus a taxpayer cannot defer such exchange gain under §§108 and 1017. Thus, the Act reverses the result reached in *Kentucky & Indiana*. In this regard, the Senate Report, at 461, states that gain realized on the repayment of a borrowing is to be attributed first to foreign currency gain and only the balance will be considered cancellation of indebtedness income. Moreover, §822 of the Act limits the ability to defer income from discharge of indebtedness to insolvent taxpayers. The combination of the reversal of *Kentucky & Indiana Terminal Co.* and the insolvency limitation for deferral of cancellation of indebtedness income means that the result under prior law will be reached only if (i) the taxpayer repays the less foreign currency than the foreign currency principal amount of the the foreign currency obligation (in which case the total gain on the repayment would exceed any exchange gain in respect of the borrowing) *and* (ii) the taxpayer is insolvent.

Another exception to the general rule that a taxpayer must recognize exchange gain or loss in respect of foreign currency debt repayments is the application of the §1092 straddle rules under the Code. Pre-Act law was unclear as to whether a foreign currency obligation was considered a "position" potentially subject to the loss deferral rules of §1092. In this regard, although the foreign currency itself could well be traded, it was not clear that a taxpayer had a position in such property by virtue of its own debt obligation. Post-1986 Act §1092(d)(7)(A) makes it clear that foreign currency debt obligations constitute positions for purposes of §1092 and thus may be subject to the loss deferral rules of that section.

[95] §988(b)(1) and (b)(2).

[96] For example, the determination of "80-20" status, which is based on the relationship between gross foreign source income and gross worldwide income could be affected by which analysis is applied.

[97] Conference Report at II-663. For an example of a constructive repayment of a borrowing *see American Air Filter Co. v. Comr.*, 81 T.C. 709 (1983) (where conversion from Dutch guilders to U.S. dollars under a loan agreement which provided that a liability payable in foreign currency could be converted to a U.S. dollar liability was treated as a realization event).

[98] *Kentucky and Indiana Terminal Railroad Co. v. Comr.*, 54 F.2d 738 (1932), cert. denied, 286 U.S. 557 (1932); *see also Gillin v. U.S.*, 423 F.2d 309 (Ct. Cl. 1970). In GCM 39294, the IRS criticized the result reached in *Kentucky and Indiana* on the grounds that the exchange gain in respect of the repayment of a foreign currency is gain from the sale or exchange of property (*i.e.*, the currency itself) under §61(a)(3) and not gain attributable to the discharge of indebtedness under §61(a)(12).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(c) Character of Exchange Gain or Loss in Respect of Borrowings

As discussed above, exchange gain or loss in respect of a foreign currency borrowing is considered ordinary in character under §988(a)(1)(A). Under pre-Act law, the character of an exchange gain or loss in respect of a foreign currency borrowing was the subject of controversy that culminated in the Sixth Circuit's *National Standard* decision (footnote 37 *supra*). In *National Standard*, the Sixth Circuit held that the repayment of a foreign currency borrowing does not involve a "sale or exchange." Since there must be a sale or exchange in order for gain or loss to be capital in character, all exchange gains and losses would be ordinary under the Sixth Circuit's rationale in *National Standard*. On the other hand, in TAM 8435006 and GCM 39294 (June 15, 1984), the IRS set forth its view that the repayment of a foreign currency borrowing constitutes a sale or exchange, and that the use of the proceeds of the borrowing determines whether any exchange gain or loss in respect thereof is ordinary or capital.[99]

(d) Source of Exchange Gain or Loss in Respect of Borrowings

Under pre-Act law, the source of exchange gain or loss in respect of the repayment of a foreign currency borrowing was extremely unsettled. As discussed at 3, (d), (1) *supra*, a number of approaches could have been used under pre-Act law, including (i) the application of the "title passage" rules for property transfers in regard to foreign currency gains (as modified by the special sourcing rule of §904(b)(3)(C)), (ii) adjusting interest expense or interst income, or (iii) a direct allocation under the rules of Regs. §1.861-8(e)(7) in respect of losses from the sale or other dispositions of property. The Act provides certainty with respect to the source of exchange gains or losses in respect of foreign currency borrowings: such gains and losses are U.S. source if the residence of the taxpayer is in the U.S. and foreign source if such residence is outside the U.S.[100] Residence in the case of an individual is his or her tax home and in the case of a corporation, partnership, trust or estate which is (i) a U.S. person, the United States, or (ii) a non-U.S. person, a country other than the United States. The residence of a QBU (including a QBU of an individual) is the country in which the principal place of business of such QBU is located.[101]

(2) Deductions for Interest and Discount in Respect of Foreign Currency Borrowings

(a) Stated Interest

The Act clarifies generally the treatment of foreign currency denominated stated interest obligations by providing that an exchange gain or loss arises to the extent that the U.S. dollar value of foreign currency stated interest expense fluctuates between the accrual date and the payment date. In this regard, a §988 transaction is defined to include the accruing of an item of expense prior to the payment of such item.[102] In addition, exchange gain or loss in respect of such expenses is defined as gain or loss attributable to such expenses to the extent such gain or loss does not exceed the gain or loss realized by reason of exchange rate changes occurring on or after the date the expense was accrued and before the date it is paid.[103] By contrast, under pre-Act law, there was no clear authority as to whether any gain or loss attributable to movements in exchange rates after the accrual and before the payment of interest expense should be viewed as exchange gain or loss or as an upward (loss) or downward (gain) adjustment to interest expense.

Example: Assume a calendar year U.S. dollar functional currency taxpayer borrowed for three years a principal amount of 100,000,000 Swiss francs at an annual stated interest rate of 5% on September 30th (Year 1). Assume also that on December 31 of Year 1, the Swiss franc exchange rate was SFr 1.66:$1 and therefore the accrued interest expense as of such date in U.S. dollar terms was approximately U.S. $753,00 (SFr interest expense for three months (SFr 1,250,000) times the spot rate (SFr 1.66:$1)).[104] If the exchange rate on September 30th (Year 2) were SFr 1.50:$1, the Swiss franc interest expense accrued in Year 1 (1,250,000) would translate into approximately U.S. $833,000. Under pre-Act law, the U.S. $80,000 difference between the U.S. dollar accrual and payment amounts arguably would have been deductible (and, for example, sourced for foreign tax credit purposes) as additional interest expense. Under the Act, however, it is clear that the U.S. $80,000 difference will be considered an exchange loss. Similarly, if the accrued interest expense had decreased in U.S. dollar terms between the accrual and payment dates (to, for example, U.S. $700,000), under pre-Act law such "gain" arguably would have reduced the amount of interest expense in Year 2. Under the Act, the taxpayer's net interest expense attributable to the SFr 1,250,000 accrued in Year 1 probably would be the Year 1 U.S. dollar accrual of U.S. $753,000, and the taxpayer will probably recognize a separate gain of U.S. $53,000 on the payment date (*i.e.*, Year 2) in respect of such accrued amount.

Under the modified separate transaction principle discussed earlier, however, it is possible that the exchange gain

[99] The IRS based its position on authorities which have held that the repayment of a debt obligation with property (but not foreign currency) resulted in a "sale or exchange." *See, e.g., Kenan v. Comr.*, 114 F.2d 217 (2d Cir. 1940) (where property was transferred in satisfaction of a legatee's claim against an estate); *Rogers v. Comr.*, 103 F.2d 790 (9th Cir. 1939), cert. denied, 308 U.S. 580 (1939) (where property was transferred in return for cancellation of a note representing part of the purchase price); Rev. Rul. 76-111, 1976-1 C.B. 214.

[100] §988(a)(3)(A).

[101] §988(a)(3)(B).

[102] §988(c)(1)(B)(ii).

[103] §988(b)(1) and (b)(2); §§988(c)(2)(B) and (c)(3)(A).

[104] There is some question whether the spot rate on the accrual date is the appropriate exchange rate to determine the U.S. dollar accrual as of such date. Since interest accrues on a daily basis, an argument might be made that an amount based on the average daily exchange rate is a more appropriate accrual amount. Although §988 does not address this question directly, it does provide for exchange gain or loss in respect of the difference between the U.S. dollar value of the interest expense on the accrual date and the U.S. dollar value of such expense on the payment date. Thus, it seems clear that the statute was based on the assumption that expenses would be accrued based on the spot rate on the accrual date. Since such treatment applies to all expenses (and income items and receivables), the statutory approach does not provide a clear indication that an expense such as interest, which accrues on a daily basis, was explicitly considered.

may be required to be netted with the Year 2 interest expense on the basis that the annual payment of stated interest should be viewed as a single transaction for purposes of applying such principle. On the other hand, the netting of such amounts arguably would not be appropriate because the Year 2 exchange gain is attributable to the Year 1 interest expense accrual and not the Year 2 interest expense amount. Since interest expense is allocated for foreign tax credit purposes under the Act on the basis of assets and exchange gain is sourced by reference to a taxpayer's residence, a netting versus separate transaction approach could (for example) have a significant impact on a taxpayer's §904 foreign tax credit limitation.[105]

(b) Original Issue Discount

Post-Act §985(a) requires that, unless otherwise provided in regulations, all determinations for federal income tax purposes must be made in a taxpayer's functional currency. The Senate Report states that, pursuant to such authority, it is anticipated that the Secretary will issue regulations providing for the determination of original issue discount ("OID") on foreign currency obligations.[106] The Report also states that pending the issuance of such regulations, it is intended that OID for any accrual period will be determined in units of foreign currency and translated into U.S. dollars based on the average exchange rate in effect during the accrual period.[107] The U.S. dollar amount deducted for an accrual period using the average exchange rate is, according to the Senate Report, the amount added in determining the adjusted issue price of the obligation for purposes of determining the amount of exchange gain or loss on its repayment.[108] Similar rules are to be applied in determining the amount of premium for an accrual period.[109] Under the Act, premium (like discount) is required to be computed on a constant rate basis.[110]

The following example illustrating the computation of OID is provided in the Senate Report:

> *Example:* On December 31, 1986, the taxpayer issues for 85.82 Deutsch marks (DM) a bond which provides for semiannual coupons of 1 DM and a final payment at maturity, on December 31, 1988, of DM100.00. The exchange rate on the date of issuance is $0.25/DM, so the amount of the borrowing initially is $21.45. The yield to maturity of the obligation, in terms of DM, is 5%, semiannually.
>
> The accrual period is 6 months, commencing with the date of issuance. At the end of the first accrual period, on June 30, 1987, the first 1 DM coupon is paid. Stated interest payments are translated at the exchange rate in effect on the payment date. If the DM appreciates to $0.35 at the end of the first accrual period, the dollar amount of stated interest is $.35 (1 DM times $0.35/DM). Accrued OID is DM3.29 (5% of DM85.82, less stated interest of 1 DM). This amount is translated into dollars using the average exchange rate during the accrual period. If the average value of the DM during the first accrual period is $0.30, the dollar amount of OID accrued on June 30, 1987 is $0.99 (DM3.29 times $0.30/DM). The taxpayer deducts the dollar amount of accrued OID (in addition to interest paid translated at the payment date) and increases its dollar basis in the bond by the same amount (from $21.45 to $22.44).
>
> As a result of the appreciation of the DM, the taxpayer has an accrued currency loss of $8.75, the difference between the dollar basis of the bond, $22.44 and the DM basis translated at the currency exchange rate, $31.19 (DM89.11 times $0.35/DM). This accrued currency loss is not recognized until the taxpayer discharges its indebtedness. The currency loss is treated as ordinary income, and is allocated by reference to the issuer's residence.[111]

Although there was no authority addressing the point, one approach taken by taxpayers prior to the Act was to compute the amount of OID in U.S. dollar terms on the basis of the exchange rate on the date the borrowing was incurred (the "issue date" approach). Any exchange gain or loss in respect of the principal amount would also be determined by reference to such exchange rate (*i.e.*, by taking the difference between the U.S. dollar amount of the obligation at the time it was incurred and the time of payment). As compared to the pre-Act approach, the Act approach would adjust the amount of OID expense upward if the foreign currency appreciated during the term of the borrowing and adjust such amount downward in the case of a depreciating foreign currency. For example, if the exchange rate on the date of issuance ($.25/DM) had been used to calculate the OID in the first accrual period, the amount of OID would have been approximately $.82 (5% of DM 85.82 (the issue price) less stated interest of lDM times the $.25/DM exchange rate) in lieu of the $.99 accrued under the Act. Thus, as contrasted with the issue date approach, the Act approach accounts for the appreciation in the DM from the date of issue ($.25/DM) through the accrual period ($.35/DM).

The higher U.S. dollar amount of OID is added to the original issue price in order to determine the adjusted issue price. Thus, under the example, the issue price in U.S. dollar terms increased from $21.45 (the U.S. dollar value of the original issue price) to $22.44 because of the $.99 OID amount computed on the basis of the average exchange rate for the accrual period. Since the amount of the exchange gain or loss at the ultimate maturity of the borrowing will be determined by reference to the adjusted issue price, the effect of using the Act approach in the example (as compared to the issue date approach) is to reallocate (and accelerate) part of the exchange loss which under the issue date approach would have been recognized at the time the borrowing is repaid.

The *total* amount of OID plus exchange loss (or less exchange gain) is the same under the Act approach and the issue date approach. The Act, however, has the effect of

[105] The U.S. dollar amount of the interest expense attributable to the SFr 3,750,000 accrued in year 2 would be the Swiss franc amount converted to U.S. dollars based on the payment date spot rate.

[106] Senate Report at 461; *see also* Conference Report at 659.

[107] Senate Report at 461.

[108] *Id.*

[109] Senate Report at 461-462.

[110] Act 643, adding subsection (e) to Code §171.

[111] Senate Report at 462.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

equating (at least to some degree) the determination of the amount of OID with the determination of the amount of interest on a stated interest borrowing (which as discussed above does take into account movements in exchange rates during the period the interest is accrued). Moreover, the Act approach arguably is more consistent with economic reality than the issue date approach to the extent the issue date approach would capture the exchange gain or loss in respect of the discount amount as an exchange gain or loss attributable to the principal repayment. On the other hand, since the discount amount is not paid until the maturity of the obligation, the taxpayer arguably has not suffered an economic detriment or realized an economic advantage until such repayment; thus the tax consequences under the Act approach arguably do not reflect the economic costs of the transaction.[112]

d. Foreign Currency Loans

(1) General Rules Applicable to Foreign Currency Loans

(a) Amount of Exchange Gain or Loss in Respect of Loans

The amount of exchange gain or loss under §988 to a lender in respect of foreign currency loans is equal to the gain or loss (under normal principles) in respect of the repayment of such a loan to the extent that such gain or loss does not exceed gain or loss realized as a result of changes in exchange rates on or after the booking date and before the payment date. Under normal principles, the gain or loss in respect of a foreign currency borrowing is equal to the difference between the U.S. dollar value of the loan at time made and the U.S. dollar value of the loan on the repayment date. The amount of such gain or loss should be the same as the determination of the amount of §988 exchange gain or loss, since such gain or loss is also is measured by movements in exchange rates between the date the loan was acquired (*i.e.*, the booking date under §988(c)(2)(A)) and the date the loan was repaid (*i.e.*, the payment date under §988(c)(3)(A)). (*See* 4, a *supra* for an example of the computation of exchange gain or loss in respect of a foreign currency loan.)

(b) Timing of Exchange Gain or Loss in Respect of Loans

The Act did not change the general principle that a lender realizes an exchange gain or loss at the time of the loan repayment. A lender also normally *recognizes* such a gain or loss at such time subject to two exceptions. First, as with foreign currency debt obligations, the §1092 straddle rules could operate the defer any such loss. In addition, in respect of foreign currency loans between related parties, §267 may operate to defer or deny any exchange loss.

In this regard, §267 generally provides that losses arising from the "sale or exchange" of property between related parties will in certain circumstances be deferred or denied. Section 267(f)(3)(C) provides that, to the extent provided in regulations, the general rule of §267(a)(1) (*i.e.*, that losses be denied in respect of a sale or exchange of property between related parties) does not apply to an exchange loss arising from the repayment of a loan made by a member of a controlled group to another member if such loan is "payable or denominated" in a foreign currency.

Temporary regulations provide that §§267(a)(1) and (f)(2) (relating to the deferral of loss in respect of the sale or exchange of property between members of the same controlled group)) will not apply to a foreign currency loss in respect of the repayment of a loan if (i) the loss is sustained by a member on the repayment to it of a loan made to another member; (ii) the loan is payable or denominated solely in a foreign currency; and (iii) the loss is attributable to a reduction in value of the foreign currency in which the loan is payable or denominated.[113]

The Conference Agreement states that the Secretary should, in light of the new Act rules, review its regulations in respect of exchange losses resulting from the repayment of a foreign currency loan made to a related party, "with a view towards conforming the regulatory exception and determining the appropriateness of applying the exception to every case that is covered by the current temporary regulations."[114] As an example, the Conference Report states that the regulations should take into account not only loans that are "payable or denominated solely in a foreign currency" but also (consistent with the coverage of multicurrency contracts under §988) loans where the principal amount is determined by reference to the value of a nonfunctional currency.[115] In addition, the Secretary is instructed to determine the extent to which the scope of the §267 regulatory exception should be narrowed.[116] In this regard, the Conference Report states that any §267 exceptions be narrowly drawn.[117]

(c) Character of Exchange Gain or Loss in Respect of Loans

Under §988, the character of exchange gains and losses in respect of foreign currency loans is ordinary.[118] By contrast, under prior law, the character of such exchange gains and losses was capital unless a statutory exception to §1221 or other judicial exception applied.[119]

---

[112] The determination of whether the OID provisions apply in respect of a particular transaction is complicated by the treatment of foreign currency as property for U.S. tax purposes. Section 1803(a)(10) of the Act (a technical correction to the Tax Reform Act of 1984 (1984 TRA) clarifies that 1273(b)(3) applies in determining the issue price of obligations that involve actively traded foreign currency. As a result, §1274, which pursuant to §1274(c)(3) does not apply to transactions covered under 1273(b)(3), does not operate to impute interest in respect of such loan. Similarly, §1803(a)(14)(B) of the Act clarifies that §483 does not apply to any debt instrument for which an issue price is determined under 1273(b)(3) and thus 483 does not apply to loans involving actively traded foreign currency. Sections 7872 (involving below market loans) and 482 may, however, still apply to impute interest in respect of foreign currency loans. In this regard, the proposed regulations provide that, in the case of a debt instrument the repayment of which is denominated in a foreign currency, the adjusted federal rate is the analogous foreign currency rate of interest. Prop. Regs. §1.7872-11(f). *See* Prop. Regs. 1.482-2(a)(2)(iii)(E).

[113] Temp. Regs. §1.267(f)-1T(h).

[114] Conference Report at II-664.

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] §988(a)(1)(A).

[119] A sale or exchange is imputed with respect to repayment of certain debt instruments under §1232(a)(1) (prior to the 1984 TRA) or under §1271(a)(1) (following the 1984 Act). For transactions not covered under

(d) Source of Exchange Gain or Loss in Respect of Loans

Under §988, any exchange gain or loss in respect of a foreign currency loan will be sourced by reference to the residence of the person on whose books such loan is properly reflected.[120] (Residence in the case of an individual is his or her tax home and in the case of a corporation, partnership, trust or estate which is (i) a U.S. person, the United States, or (ii) a non-U.S. person, a country other than the United States. The residence of a QBU (including a QBU of an individual) is the country in which the principal place of a business of such QBU is located.)

As discussed above (*see* 3, d, *supra*), pre-Act law regarding the sourcing of exchange gains and losses was extremely unsettled. In respect of a foreign currency loss, the imputed sale or exchange by the holder upon its receipt of the repayment of a foreign currency loan under §1271(a)(1) (or §1232(a)(1) prior to the 1984 TRA) may well have triggered the rules of Regs. §1.861-8(e)(7), with interest income possibly being the income normally produced by the property (*i.e.*, the loan receivable). On the other hand, consistent with the separate transaction principle, the currency could have been the "property" the income from which needed to be traced. Again, the fact that currency might not "ordinarily" have given rise to any particular class of gross income in the hands of a taxpayer would indicate that the application of Regs. §1.861-8(e)(7) was inappropriate. Thus, a general allocation of the loss to all classes of gross income and an apportionment between foreign and U.S. sources in accordance with the ratios of the taxpayer's foreign and U.S. source gross income, respectively, to worldwide gross income may have been the more appropriate allocation and apportionment.[121] In respect of an exchange gain, a strained application of the title passage rule may have been the proper approach, with the possible application of the §904(b)(3)(C) resourcing rule in the case where title passed outside the U.S.

(2) Stated Interest and OID

The discussion in c, (2), (a) and (b) *supra* regarding the determination of the amount of stated interest expense and OID deductions in regard to foreign currency borrowings applies equally to the determination of the amount of stated interest income and OID income in respect of a foreign currency loan.[122]

e. Forward, Futures and Options Contracts

(1) General Rules

(a) §988 Transactions

Section 988(c)(1)(B) defines a §988 transaction to include entering into or acquiring any forward, futures or option contract or similar financial instrument, if such contract or instrument is not marked to market under §1256. Contracts that are marked to market under §1256 continue to be governed by the separate taxing scheme of that section and are not covered by §988. In order to determine, therefore, whether a forward, futures or options contract is covered by §1256, it is necessary to determine whether such contract is outside the scope of §1256.

The mark to market rules of §1256 do not apply to hedging transactions (with respect to which the requirements of §1256(e) are satisfied) and therefore these transactions are covered (as discussed below) under the rules applicable to §988 hedging transactions. The Conference Report makes clear that the definition of a §988 transaction includes all "§1256 contracts" excluded from the coverage of that section by virtue of the mixed straddle election of §1256(d), since such contracts are not marked to market under the rules of §1256.[123] In addition, all forward, futures and options contracts and similar financial instruments denominated in a nonfunctional currency, other than "regulated futures contracts," "foreign currency contracts," "nonequity options" and "dealer equity options," all as defined in §1256(g), are outside the scope of §1256 and therefore are §988 transactions.

In order for a futures contract to constitute a "regulated futures contract,"§1256(g)(1)(B) provides that the contract must be traded on or subject to a "qualified board or exchange." The term "qualified board or exchange" is defined by §1256(g)(7) to include only certain domestic exchanges (*i.e.*, national exchanges registered with the SEC) and boards of trade (*i.e.*, those designated by the Commodity Futures Trading Division), and such other exchange, board of trade or market as is designated in regulations promulgated by the Secretary. At present, the only foreign exchanges that constitute "qualified boards of exchange" within the meaning of §1256(g)(7) are the Mercantile Division of the Montreal Exchange and the International Futures Exchange (Bermuda) Ltd.[124] All futures contracts denominated in a foreign currency and not traded on either an appropriate domestic exchange or board of trade or a foreign exchange (presently only the two listed above) designated by the Secretary would therefore be covered by §988.

A contract to purchase or sell foreign currency is a "foreign currency contract," within the meaning of §1256(g)(2), only if such contract is denominated in a currency traded on a "qualified board or exchange" (as defined above). Currently, only the British pound, Canadian dollar, Dutch guilder, ECU (European currency unit), French franc, German mark, Japanese yen, and Swiss francs are so traded. Therefore, exchange gain or loss attributable to a forward or other contract denominated in any other currency would be covered by §988. Section 1256(g)(2) also provides, in effect, that §1256 applies only to a contract which is traded in the interbank market. Therefore, a contract denominated in one of the eight currencies discussed above, but which is not interbank traded (*e.g.*, in the case of a currency swap and possibly a long-term forward contract), also is not a §1256 contract and therefore is covered by §988.

such sections, the Supreme Court's decision in *Fairbanks v. U.S.*, 306 U.S. 436 (1939), which held that the repayment of a debt does not involve a sale or exchange in respect of the creditor, would control.

[120] §988(a)(3)(A).

[121] Regs. §1.861-8(b)(5); Regs. §1.861-8(a)(2).

[122] *See also* footnote 112 *supra*, regarding the application of the §1274 deferred payment rules and §7872 below market interest rules to foreign currency obligations.

[123] Conference Report at II-663.

[124] Rev. Rul. 86-7, 1986-4 I.R.B. 6; Rev. Rul. 85-72, 1985-1 C.B. 286.

An option denominated in a foreign currency is a "nonequity option" under §1256(g)(3) if such option does not relate to stock (or to the value of stock) and is traded on a "qualified board or exchange" (as defined above). Any option denominated in foreign currency (*e.g.*, an option to acquire a foreign currency-denominated debt instrument) which is not traded, or is not traded on a "qualified board or exchange," is not a "nonequity option" within the scope of §1256 and thus is covered by §988.

A "dealer equity option," which is the final category of transactions covered by §1256, is defined, in general, as any listed option which is (i) an option to buy or sell stock (or an option the value of which is determined by reference to a stock or stock index); (ii) purchased or granted by an options dealer in the normal course of its options-dealing activity; and (iii) traded on a "qualified board or exchange" on which such dealer is registered. §1256(g)(4). Any foreign currency-denominated equity option (*e.g.*, a sterling denominated stock option) held by an options dealer, if such option is not a "dealer equity option" within the meaning of §1256(g)(4), is covered by §988. Taking into consideration the above definition of "dealer equity option," §988 applies to options (denominated in a nonfunctional currency) held by an options dealer which were not acquired in the normal course of the dealer's option-trading activity, or are not traded on a "qualified board of exchange" (as discussed above) on which the options dealer is registered.[125]

(b) Amount and Timing of Exchange Gain or Loss

As discussed above, §988 did not effect normal realization principles under the Code and therefore such principles apply in determining if (and when) any gain or loss exists in respect of a forward contract, futures contract, or option contract. In this regard, a taxpayer may realize gain or loss in respect of a forward, futures or option contract if such contract is sold, or terminated by offset (assuming a closeout is effected) or cancellation.[126] The amount of such realized gain or loss will be measured by reference to the spot rate at the time of such sale or termination and the forward rate (or strike price) in respect of the contract.[127]

As relevant to forward, futures and option contracts, §988 defines exchange gain or loss as gain or loss realized under normal principles to the extent that such gain or loss is attributable to movements in exchange rates between the date on which the position is entered into or acquired (*i.e.*, the booking date in respect of such a transaction) and the date on which payment is made or received, or the date the taxpayer's rights with respect to the position are terminated (*i.e.*, the payment date in respect of such a transaction).[128] Thus, in respect of a gain or loss arising from the sale or termination by offset or cancellation of forward, futures or options contracts, the gain or loss would be considered foreign currency gain or foreign currency loss subject to the §988 rules.

If the closeout is effected by delivery, however, the realization event is not the closeout of the contract itself but rather the disposition of the currency acquired (in the case of, for example, a forward purchase contract) or "sold" (in the case of, for example, a forward sale contract) pursuant to the contract. The amount of the gain or loss in respect of such disposition is the difference between the taxpayer's functional currency basis in the nonfunctional currency and the amount of functional currency realized in respect of its disposition. The gain or loss therefore is attributable to the disposition of the currency and not attributable to the contract itself. As such, the disposition qualifies as a §988 transaction under §988(c)(1)(C) (*i.e.*, as a disposition of currency) and the amount of §988 foreign currency gain or loss is equal to the realized gain or loss disposition of the currency to the extent that such gain or loss is attributable to movements in exchange rates between the time the currency was acquired (*i.e.*, the booking date in respect of such a transaction) and the time of disposition of the currency (*i.e.*, the payment date in respect of such a transaction).[129]

Since the amount of the gain or loss in respect of the disposition of the currency is determined by reference to the forward rate (or strike price), it is entirely possible that the gain or loss in respect of the currency disposition will not (at least in part) be attributable to movements in exchange rates *after* the acquisition date. Rather, such gain or loss may be determined primarily by the movement of the spot rate relative to the forward rate (or strike price) *before* the disposition (in the case of, for example, a forward sale or put option) or acquisition (in the case of, for example, a forward purchase or call option) of the currency pursuant to the contract. Thus, arguably most (if not all) of the gain or loss in respect of a closeout by delivery of a forward, futures or option contract technically may not be foreign currency gain or loss for purposes of §988 and as a result will be subject to the rules (and uncertainties) of pre-Act law in respect of the character and source of the gain or loss.

It does not appear that Congress intended to exclude gains or losses related to the close out by delivery of a forward, futures, or option contract. The statute, however, may need to be amended in order to include such gains and losses within the definition of §988 foreign currency gains or foreign losses.

(c) Character of Exchange Gain or Loss

Section 988(a) provides, in effect, that exchange gain or loss attributable to a §988 transaction will generally be characterized as ordinary income or loss. A limited excep-

[125] The Act, §1261(c), repeals the provisions of pre-Act §1256(e)(4), which allowed a bank to elect hedging treatment without satisfying the requirements of §1256(e)(A)(i) or (ii) (*i.e.*, that the hedging transaction was entered into to reduce the risk of price change or currency fluctuations with respect to property held or to be held, or that such transaction was entered into to reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred). As a result of the amendment, if a bank executes a foreign currency forward, futures or options contract or other similar financial instrument which does not meet the requirements of §1256(e)(A)(i) or (ii), such contract or instrument will be covered by §988.

[126] In respect of contract subject to §1256, however, a taxpayer may be required to mark to market the contract prior to a closeout of the contract.

[127] The §1092 straddle rules may operate to defer any loss in respect of such instruments.

[128] §988(c)(2)(C) and (3)(B).

[129] §988(c)(1)(C)(i)(I) and (II).

tion to this general rule is available to an electing taxpayer with respect to exchange gain or loss attributable to a forward, futures or option contract if such contract is a capital asset and is not part of a "straddle" (within the meaning of §1092(c)). In such case, a taxpayer can elect to treat the gain or loss attributable to the contract as capital gain or loss if the taxpayer makes an election which identifies the transaction related to the contract on or before the close of the day on which such transaction is entered into. §988(a)(1)(B). As discussed above, the election, subject to regulations to be promulgated, presumably was included to allow for consistent treatment as to character between a non-§1256 contract which is a capital asset (and which would be a §1256 contract but for the technical requirements of the statute (*e.g.*, must be traded on a "qualified board or exchange")) and a §1256 contract.

(d) Source of Exchange Gain or Loss

Section 988(a)(3) clarifies the rules as to source of exchange gain or loss by providing that such gain or loss is sourced by reference to the residence (determined pursuant to the rules discussed at 3, d, (2) *supra*) of the taxpayer or the QBU on whose books the §988 transaction is properly reflected. The Conference Report, at II-668, makes clear that amounts treated as capital gain or loss (pursuant to the election discussed above) are also sourced by reference to residence of the taxpayer.

f. Currency Swaps

(1) General Consequences of §988 Swaps

(a) Swaps as §988 Transactions

Section 988 applies to the entering into or acquiring of any forward contract, futures contract, option or "similar financial instrument" if such instrument is *not* marked to market at the close of the taxable year.[130] It is clear from the legislative history of the Act that currency swaps were intended to be covered as "similar financial instruments" and since currency swaps are not traded and therefore do not fall within the definition of a §1256 contract, such swaps will be considered §988 transactions.[131]

(b) Timing and Amount of Swap Exchange Gain or Loss

A currency swap is a contractual arrangement pursuant to which two parties agree to make payments to each other in different currencies. A swap party normally will either be receiving or delivering its functional currency and both parties normally will make a series of annual payments followed by a single lump sum payment.

As discussed above, §988 did not affect normal realization principles under the Code. The application of such realization principles to a swap, however, first depends upon the U.S. tax characterization of such an agreement. If a swap is considered to be a series of purchases (in the case where the swap party is acquiring a nonfunctional currency) or sales (in the case where a swap party is disposing of a nonfunctional currency) the same analysis (and uncertainties) discussed above in regard to forward, futures and options contracts closed out by delivery applies to swap payments. If the swap is terminated prior to its maturity, however, any income or loss realized in respect of any early termination payment from or to a swap party would likely be a §988 foreign currency gain or loss to the extent it is attributable to movements in exchange rates after the date the swap was entered into (*i.e.*, the booking date in respect of the swap itself) and before the parties rights were terminated (*i.e.*, the payment date in respect of the swap itself).

A swap may also be viewed as a series of gross payments (*e.g.*, interest payments, financial service fees or other nondescript income or expense under §§61 and 162, respectively). As such, the payments would be deductible and includible and would result in exchange gain or loss for §988 purposes consistent with such characterization. Thus, if viewed as interest payments on loans, the interest expense and income attributable to the annual swap payments would generate §988 exchange gain or loss only if exchange rates moved between the accrual and payment dates. (*See* example in c, (2), (a) *supra.*) In addition, as repayments of loans, the final swap payments could produce §988 foreign currency gain or loss attributable to exchange rate movement between the date the loan was incurred and the repayment date. (*See* discussion in d, (1), (a) *supra.*) As under the "purchase" or "sale" characterization discussed above, an early termination payment from or to a swap party would likely be viewed as §988 foreign currency gain or loss to the extent such gain or loss is attributable to movements in exchange rates between the date the swap was entered into and the date the rights of the swap parties were terminated.

(c) Character of Swap Exchange Gain or Loss

To the extent that gain or loss in respect of a swap is considered to be §988 foreign currency gain or loss, such gain or loss would be treated as ordinary income or loss under §988(a)(1)(A).[132] In respect of exchange gains and losses from currency swaps which are not considered §988 foreign currency gains or losses, the character of such gain or loss would be ordinary unless the swap was characterized as a series of purchases and sales, in which case the gain or loss would be capital unless a statutory exception to §1221 or a judicial exception to capital gain or loss treatment applied.

(d) Source of Swap Exchange Gain or Loss

The source of any exchange gain or loss from swaps would be determined by reference to the residence of the swap party to the extent such gain or loss qualified as §988 foreign currency gain or loss. (*See* discussion in 3, d, (2) *supra*, regarding the residence of a taxpayer for purposes of the §988 sourcing rules.) To the extent the swap gain or loss falls outside of §988, the confused source (and allocation and apportionment) rules for property dispositions (discussed in 3, d, (1) *supra*) would apply.

[130] §988(c)(1)(B)(iii).

[131] *See, e.g.*, Senate Report at 460; §1256(g)(1) and (2); §988(c)(1)(B)(iii).

[132] The capital gain and loss election under §988(a)(1)(B) does not apply to "other financial instruments" such as currency swaps. §988(a)(1)(B) and (c)(1)(B)(iii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(2) Withholding Tax Implications of Swap Payments

The Conference Report states that "the Secretary will address the appropriate treatment of payments made to a counterparty under a swap transaction for purposes of withholding under sections 871 and 881."[133]

g. Hedging Transactions

(1) Definition of §988 Hedging Transactions

Section 988(d)(1) requires that, to the extent provided in regulations, if a §988 transaction is part of a §988 hedging transaction, all transactions which are part of the hedging transaction shall be integrated and treated as a single transaction, or otherwise treated consistently for §988 purposes. A §988 hedging transaction is any transaction identified by the Secretary or the taxpayer as being a §988 hedging transaction and entered into by the taxpayer primarily to (i) reduce risk of currency fluctuations with respect to property which is held or to be held by the taxpayer or (ii) reduce the risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred by the taxpayer.[134]

The definition of a §988 hedging transaction tracks the definition of such a transaction under §1256(e), except that a §988 hedging transaction need not be entered into in the "normal course" of a taxpayer's trade or business and the gain or loss from the hedging transaction need not be treated as ordinary income or loss.[135] The Conference Report states that regulations will require taxpayers to clearly identify a hedging transaction before the close of the day the transaction is entered into in order to claim increased deductions attributable to a hedge, while the Secretary may identify the transaction at a later date.[136]

Section 988(d)(1) also provides that the determination of whether any transaction is a §988 transaction is made without regard to whether the transaction is marked to market under §1256. Absent this modification, a §988 transaction would (and therefore a §988 hedging transaction may) exclude transactions which are marked to market.[137] Section 988(d) also provides that §§1256 and 1092 do not apply to a transaction which meets the definition of a §988 hedging transaction. In addition, §988(d) makes clear that §988 hedging transactions do not include transactions with respect to which a §988(a)(1)(B) capital gain or loss election has been made.

It is not entirely clear under the definition of a §988 hedging transaction whether all transactions which are part of such transaction must fall within the definition of a §988 transaction. In this regard, §988(d) provides that "if any section 988 transaction is *part* of a §988 hedging transaction *all* transactions which are *part* of such §988 hedging transaction" shall be integrated or otherwise treated consistently (emphasis added). Thus, on its face, the statute would appear not to require that all transactions which are part of the §988 transaction be §988 transactions, but rather only that §988 transactions form part of such hedging transactions.

(2) Fully Hedged Transactions

As discussed above, §988(d) requires that §988 hedging transactions will, to the extent provided in regulations, be "integrated and treated as a single transaction or otherwise treated consistently" for purposes of §988. The legislative history divides hedging transactions into two categories: fully hedged transactions, which, to the extent provided in regulations, will be "integrated and treated as a single transaction," and partial hedges, which, to the extent provided in regulations, will be treated "consistently."[138] In this regard, the legislative history provides that fully hedged transactions are the "narrow class" of transactions that are part of an integrated economic package through which the taxpayer has locked in its functional currency cash flow, thus making exchange rate movements irrelevant.[139] As to such fully hedged transactions, the legislative history states that, to the extent provided in regulations, the form of the transaction will be disregarded and the various legs of the hedging transaction will be collapsed and treated in a manner consistent with the substance of the transaction.[140]

An example of a fully hedged transaction in the Conference Report is a fully hedged foreign currency borrowing in which a U.S. dollar functional currency taxpayer borrows foreign currency and enters into a series of forward contracts (or a currency swap) which will assure the taxpayer of a fixed U.S. dollar cost for the foreign currency necessary to service the interest and principal payments in respect of the borrowing. The Conference Report states that such a borrowing will be treated under the regulations as a U.S. dollar borrowing with U.S. dollar interest payments. Conference Report at II-666.

The following example illustrates the proposed Act treatment of a borrowing fully hedged by a series of forward contracts.

Example: Assume a U.S. dollar functional currency taxpayer enters into a series of forward purchase contracts (*i.e.*, contracts which require the taxpayer to pay U.S. dollars for Swiss francs) to hedge its exchange exposure associated with a 5-year 170,000,000 (net proceeds 166,000,000) Swiss franc borrowing carrying a 5% rate of interest. Assume the borrowing and the forward contracts produce the following U.S. dollar and Swiss franc cash flows.

	SFr (Proceeds) Interest and Principal	Forward (Spot) Rate	(Proceeds and Forward Purchase Contracts
Borrowing Date	(166,000,00)	(1.66)	($100,000,000)
Year 1	8,500,000	1.62	5,246,900
Year 2	8,500,000	1.58	5,379,700
Year 3	8,500,000	1.54	5,519,400
Year 4	8,500,000	1.49	5,704,700
Year 5	8,500,000	1.44	5,902,700
Year 6	170,000,000	1.44	118,055,000

[133] Conference Report at II-668.
[134] §988(d)(2).
[135] §1256(e)(2)(A); §1256(e)(2)(B).
[136] Conference Report at II-667.
[137] §988(c)(1)(B)(ii); §988(d)(1).
[138] Conference Report at II-666. Prompt regulatory guidance is expected with respect to typical fully hedged transactions (*e.g.*, a fully hedged foreign currency borrowing).
[139] Conference Report at II-666.
[140] Senate Report at 464-465; House Report at 475-476.

Since the taxpayer has entered into forward purchase contracts to hedge each of its Swiss franc outflows (both principal and interest), the borrowing has been fully hedged into U.S. dollars. Since the Swiss franc is a "strong" currency, the U.S. dollar cost of the Swiss francs necessary to service the interest payments increases gradually over the term of the borrowing in order to account for the interest differential between the U.S. dollar and the Swiss franc. (In other words, since a person could invest U.S. dollars at a rate of interest higher than it could invest Swiss francs, the premium built into the forward rate is necessary to compensate for the delayed U.S. dollar payment which will be made to acquire the Swiss franc.) [141] The same premium also is reflected in the difference between the U.S. dollar value of the proceeds of the borrowing ($100,000,000) and the U.S. dollars cost of Swiss francs necessary to service the principal amount ($118,055,000).

The Act contemplates that the forward purchase contracts entered into for the purpose of hedging the interest and principal payments in respect of the Swiss franc borrowing be integrated with such borrowing and that the combined transaction be treated as a U.S. dollar borrowing. As such, the U.S. dollar payments made pursuant to the forward contracts would be considered the interest expense associated with the borrowing for U.S. tax purposes and the difference between the U.S. dollar issue price of the debt ($100,000,000) and the redemption price ($118,000,000) will be treated as original issue discount for U.S. tax purposes. Moreover, characterized as a U.S. dollar borrowing, there will be no exchange gain or loss associated with the repayment of the borrowing. Under pre-Act law, the taxpayer would not receive any benefit in respect of the premium paid to acquire the Swiss franc principal amount until such amount was paid, at which time the taxpayer would acquire a basis in the Swiss franc that would reduce any exchange gain or increase any exchange loss in respect of the repayment of the borrowing.

By contrast, if the taxpayer borrowed in weak currency relative to its functional currency and hedged such borrowing back into its functional currency, the effect of the integration of the two transactions would be to reduce current interest deductions for the premium which the taxpayer will earn in the transaction. Thus, as contrasted with pre-Act law, the approach under the Act will accelerate income in respect of weak currency borrowings fully hedged with forward contracts and will accelerate deductions in respect of strong currency borrowings fully hedged with forward contracts.

The §988 hedging transaction rules apply not only to forward contracts but also to currency swaps, cross-currency interest rate swaps and virtually any other contract to buy or sell a nonfunctional currency.[142] It is not clear whether currency options used to offset downside currency exposure (but which continue the upside potential) will also be accorded hedging treatment, although at least one commentator has argued that such instruments should be so treated.[143] The Conference Report clarifies that the hedging transaction rule is not limited to U.S. dollar denominated transactions, but may also be applied where a U.S. dollar functional currency taxpayer enters into several positions to establish a foreign currency position.[144] Finally, the legislative history makes it clear that the §988 hedging transaction rules apply to nonfunctional currency investments which are hedged back into the taxpayer's functional currency.[145]

(3) Partial Hedges

As discussed above, the legislative history states that, to the extent provided in regulations, partial hedges will be treated "consistently." [146] A partial hedge is defined as a series of transactions which are not entered into as an integrated economic package but rather are designed to limit a taxpayer's exposure in a particular currency.[147] The Conference Report provides as an example of a partial hedge the acquisition of a foreign currency denominated liability to offset exposure with regard to a foreign currency denominated asset. In respect of partial hedges, the Conference Report states that the regulations need not provide for complete integration but should provide for consistent treatment with respect to character, source and timing. Partial hedges, like fully hedged transactions, must be identified by the taxpayer (or by the Secretary) in order to qualify as §988 hedging transactions.[148]

5. Effective Date

Section 988 is effective generally for taxable years beginning after December 31, 1986. It is not certain whether foreign currency transactions entered into prior to the general effective date but which produce tax consequences after the general effective date will be covered under §988. The tax consequences in respect of, for example, the repayment of a foreign currency borrowing entered into prior to the general effective date and repaid after such date almost certainly will be covered under §988. A more difficult question arises, however, in respect of transactions such as hedging transactions with respect to which the tax treatment depends substantially on the initial purpose for the transaction. Another concern may be that covering certain transactions (*e.g.*, a currency swap where one or more payments were made on or prior to December 31, 1986) could result in disparate consequences in respect of identical parts of the same transaction. On the other hand, considering the substantial uncertainty under prior law (discussed above) in respect of the proper tax treatment of foreign currency transactions, any such disparate treatment may be outweighed by the advantage of additional clarity in respect of such transactions.

C. Foreign Currency Translation

1. Background

a. Determination of U.S. Dollar Taxable Income or Loss

When U.S. taxpayers operate abroad through a branch or subsidiary corporation that maintains books and records

[141] See Senate Report at page 440; House Report at 455-456.
[142] Conference Report at II-667.
[143] O'Neill and Lee, footnote 59 *supra*, at 195.
[144] Conference Report at II-666.
[145] *Id.*
[146] Conference Report at II-666-667.
[147] Conference Report at II-666.
[148] Conference Report at II-666-667.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

in a foreign currency, the operating results of the foreign business must be translated into U.S. dollars for U.S. tax purposes. In the case of a foreign branch, profit or loss must be translated into U.S. dollars and included currently in the computation of taxable income of the U.S. taxpayer. In the case of a foreign subsidiary, any actual or deemed distributions and the earnings and profits from which they are derived must be translated into U.S. dollars to determine taxable income of the U.S. parent corporation in respect of such distributions.

Taxable income in U.S. dollars in respect of a foreign business may consist of (i) operating profit or loss computed in foreign currency and translated into U.S. dollars at an appropriate exchange rate, and (ii) foreign exchange gain or loss arising from the translation of foreign currency financial statement items into U.S. dollars or the remittance of capital from the foreign business.[149] The extent to which foreign exchange gain or loss in respect of foreign operations of a U.S. taxpayer is recognized currently for U.S. tax purposes depends upon the method used to translate the results of those operations. Under rules in effect prior to the Tax Reform Act of 1986, translation methods varied depending primarily upon the form in which foreign activities were conducted and the magnitude and continuity of foreign currency denominated transactions. In certain circumstances, U.S. taxpayers were entitled to choose from among optional translation methods, and substantially different U.S. tax consequences often resulted, depending upon the method ultimately selected.

b. Determination of Allowable Foreign Tax Credits

Translation of foreign currency into U.S. dollars is also relevant to the computation of a U.S. taxpayer's credit against U.S. tax for foreign taxes incurred in respect of foreign operations. In the case of foreign branch operations, the key question is what exchange rate should be used to translate into U.S. dollars foreign taxes paid or accrued. The answer to this question becomes more complicated where the exchange rate changes between the time the foreign tax is accrued and the time it is paid, or where the amount of foreign taxes originally paid or accrued is later adjusted. In the case of foreign operations conducted through a foreign subsidiary, additional foreign tax credit questions relate to the appropriate exchange rate to be used to translate into U.S. dollars actual or deemed distributions and earnings and profits of the foreign subsidiary.

2. Profit or Loss of Foreign Branch

a. Prior Law

Under prior law, if a U.S. taxpayer conducted activities abroad but did not maintain separate books and records for such activities, realized exchange gains and losses resulting from each non-U.S. dollar denominated transaction generally were required to be recognized (under the so-called "specific transactions" method) when the transaction was closed.[150] In the case of a foreign branch, however, local currency tends to lose its character as property because it is dealt with as money, and the U.S. dollar becomes an inappropriate measure of the effect of exchange rate changes. Thus, from the outset, U.S. taxpayers were permitted, as alternatives to the specific transactions method in respect of foreign branch operations, either to recognize currently exchange gains and losses in respect of foreign branch operations (under the so-called "net worth" or "balance sheet" currency translation method) [151] or to defer recognition of such gains and losses until realized when capital ultimately was remitted to the U.S. and converted into U.S. dollars (under the so-called "profit and loss" currency translation method).[152] The implicit eligibility requirement for avoiding the recognition of exchange gains and losses under a specific transactions method was the existence of a foreign branch operation the books and records of which were maintained in foreign currency.[153]

(1) Net Worth Method

Under the net worth method of accounting for taxable income or loss in respect of a foreign branch, in broad terms the difference between the foreign branch's beginning and ending net worth, as translated into U.S. dollars, for any year was deemed to be the annual profit or loss of the branch for U.S. tax purposes.[154] Current assets and liabilities in practice typically were translated at current rates, whereas fixed assets and long-term liabilities were translated at historical rates (*i.e.*, the rate in effect when the asset was purchased or the liability incurred). Remittances from the branch to the home office were translated at the exchange rate in effect on the date of remittance and added to the increase in net worth for purposes of determining taxable income in respect of the branch. No precise rules were provided for purposes of determining the source or character of income attributable to a branch.

Under the net worth method, the increase or decrease in the dollar equivalent of net worth for any taxable year encompasses both operating profit or loss and any exchange

[149] In general, the term "foreign exchange gain or loss" embraces gain or loss that arises when a transaction is denominated (requires settlement) in a foreign currency and the value of the foreign currency changes between the time the transaction is entered into and the time it is closed (*i.e.*, realized exchange gain or loss) as well as translation gain or loss (also commonly referred to as unrealized exchange gain or loss), which arises from the translation of foreign currency financial statement items into U.S. dollars. *See, e.g.*, Department of the Treasury, Office of the Secretary, "Taxing Foreign Exchange Gains and Losses," 45 Fed. Reg. 81711 (Dec. 11, 1980). Although translation gains and losses are often referred to as unrealized, they may consist of both realized and unrealized amounts. For example, if the value of foreign currency declines relative to the U.S. dollar, the sale of a foreign currency denominated investment security results in a realized exchange loss under closed transaction principles, whereas the holding of foreign currency between balance sheet dates results in an unrealized exchange loss.

[150] *See* discussion in II, B *supra*.

[151] O.D. 489, 2 C.B. 60 (1920), superseded by Rev. Rul. 75-106, 1975-1 C.B. 31; A.R.R. 15, 2 C.B. 60 (1920), declared obsolete in Rev. Rul. 67-211, 1967-1 C.B. 399. *See also Frederick Vietor & Achelis v. Salt's Textile Mfg. Co.*, 26 F.2d 249 (D. Conn. 1928); Rev. Rul. 75-134, 1975-1 C.B. 33.

[152] O.D. 550, 2 C.B. 61 (1920), superseded by Rev. Rul. 75-107, 1975-1 C.B. 32. *See also American Pad & Textile Co. v. Comr.*, 16 T.C. 1304 (1951), acq., 1951-2 C.B. 1.

[153] Rev. Rul. 75-109, 1975-1 C.B. 69.

[154] There are several variations of the net worth method depending upon the rates selected to translate particular balance sheet items. The only method accurately described as the net worth method converts *all* foreign currency assets and liabilities into dollars at the rates in effect at the beginning and the end of the year, respectively. *See* O.D. 489, footnote 151 *supra*, fn. [3].

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(balance sheet translation) gain or loss for the year. Exchange gain or loss in respect of any balance sheet item translated at historical rates was deferred, whereas such gain or loss in effect was recognized currently in respect of items translated at current rates. Although the method thus simulated the results produced by a specific transactions method, the net worth method failed to separate operating profit or loss from exchange gains and losses and resulted in current recognition of unrealized as well as realized exchange gains and losses. The recognition of unrealized exchange gains and losses, of course, represented a departure from the normal tax accounting principle that gains must be realized before being recognized.

(2) Profit and Loss Method

Under prior law, the profit and loss method of accounting for branch income started with the profit and loss statement prepared for the branch in local currency. Profit retained by the foreign branch was translated into U.S. dollars at the rate of exchange in effect as of the reporting date, while current profits remitted to the home office were translated at the rate of exchange in effect at the date of the remittance. Accordingly, taxable income in respect of the branch amounted to the U.S. dollar equivalent of the branch profit as expressed in foreign currency, and foreign exchange gains and losses were deferred until capital ultimately was remitted to the U.S. home office and converted into U.S. dollars.

Prior law did not provide precise rules for determining exchange gain or loss under the profit and loss method when remittances from a foreign branch exceeded current annual profits. For example, it was not entirely clear under the profit and loss method whether exchange gain or loss should be deferred until a branch was liquidated or whether it should be recognized whenever remittances exceeded current profits. There also were no specific rules applicable to the translation of branch losses or to the determination of the source or character of gains or losses attributable to branch remittances.

(3) Specific Transactions Method

Under prior law, a U.S. taxpayer that conducted foreign operations through a foreign branch was also permitted to use a specific transactions method of accounting for its foreign branch. This was most appropriate where the foreign investment was temporary or dependent on the U.S. dollar economy.[155] In such a case, closed transaction principles required purchases and sales and payments and receipts of the foreign branch to be translated into U.S. dollars at the rate of exchange existing at the date of the respective transactions, and the U.S. home office realized and recognized currently for U.S. tax purposes exchange gains and losses as transactions were closed by its foreign branch. In practice, the specific transactions method by definition was impracticable, and therefore seldom used, where the volume of foreign currency transactions was more than minimal or where the foreign branch was conducted as a substantially independent operation.

[155] *See Comr. v. American Metal Co.*, 221 F.2d 134 (2d Cir. 1955), cert. denied, 350 U.S. 829.

Before the Tax Reform Act of 1986, the primary limitation on a U.S. taxpayer's selection of a foreign currency translation method was whether the method selected resulted in the clear reflection of income. Once a method was selected, any change in that method was considered a change in method of accounting to which the provisions of §§446 and 481 applied.[156]

b. Overview of Changes

Section 1261 of the Tax Reform Act of 1986 adds new §§985-989 to the Code, which consolidate and substantially revise prior rules applicable to the translation into U.S. dollars of the operating results of foreign branches.

Under new §987, U.S. taxpayers with branch operations abroad constituting qualified business units ("QBUs") that use a functional currency other than the U.S. dollar generally are required to use a modified version of the profit and loss translation method of prior law.[157] Under this method, profit or loss determined in the foreign functional currency is to be translated into U.S. dollars, pursuant to new §989(b)(4), using a weighted average exchange rate. In addition, under new §987(3), exchange gain or loss is to be recognized on remittances made by a foreign branch to the U.S. taxpayer's home office to the extent that the value of the foreign functional currency relative to the U.S. dollar when remitted differs from the value when earned. Such exchange gains or losses will be treated as ordinary and sourced by reference to the income giving rise to post-1986 accumulated earnings (generally the residence of the branch, unless its income is derived from U.S. sources).[158]

c. Reasons for Changes

Before the U.S. abandoned the gold standard, multinational enterprises were confronted with an international economic environment typified by prolonged and steady declines in the value of foreign currencies relative to the U.S. dollar. In such an environment, currency movement typically had a permanent impact on the U.S. dollar value of a foreign investment, and current recognition of foreign exchange gains and losses therefore was key to any accurate reflection of operating results. By contrast, with the advent of floating exchange rates, mere transitory movements in currency value arguably lack the lasting economic impact on long-term investment positions that previously justified current recognition of exchange gains and losses.

The legislative history of the Tax Reform Act of 1986 evidences a congressional concern that in a world of floating exchange rates it is inappropriate for a U.S. taxpayer conducting branch operations abroad primarily in a foreign

[156] *See American Rod & Tackle Co. v. Comr.*, 16 T.C. 1304 (1951), acq., 1951-2 C.B. 1; Rev. Rul. 75-106, 1975-1 C.B. 106.

[157] Under the new law, taxpayers operating abroad other than through a QBU will generally be required to use a specific transactions method in respect of non-U.S. dollar denominated transactions. The net worth method of prior law has been eliminated.

[158] It is not entirely clear at this time how distributions from pre-1987 accumulated earnings of a foreign branch will be treated for U.S. tax purposes. Preliminary indications are that an attempt will be made to retain the integrity of prior law treatment with respect to such distributions. U.S. taxpayers may be required to retain their existing accounting methods to account for distributions from pre-1987 earnings.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

currency to recognize exchange gain or loss before property is repatriated to the U.S. from the foreign environment. However, certain foreign currencies continue to be marked by constant depreciation relative to the U.S. dollar, which would perhaps justify the continued ability of U.S. taxpayers operating in those environments to recognize currently exchange losses in order to reflect accurately their income for U.S. tax purposes. There are indications in both the House and Senate Committee Reports on tax reform that Congress was not unmindful of this fact.[159] Nevertheless, there apparently was an overriding concern that if, as under prior law, U.S. taxpayers were permitted to choose between optional translation methods, they would elect the net worth method for branch operations in countries with a weak currency (to accelerate losses) and the profit and loss method for operations in countries with a strong currency to defer gain).[160] The net worth method also was heavily criticized for causing the recognition of certain exchange gains and losses prior to their realization and for failing to characterize accurately certain items of income or loss that are subject to special U.S. tax rules.[161]

d. Detailed Analysis

Under new §987, a U.S. taxpayer that has a foreign branch operation constituting a "qualified business unit" ("QBU") with a functional currency other than the U.S. dollar must use the profit and loss method to translate into U.S. dollars the results of operations of the QBU. The net worth method, which resulted in current recognition of both realized and unrealized exchange gains and losses, is no longer permitted in determining taxable income or loss in respect of foreign branch operations. In this connection, new §989(c)(1) requires Treasury to issue regulations setting forth procedures to be followed for purposes of changing from a net worth method of accounting for branch operations for years prior to 1987 to the profit and loss method prescribed by new §987. The regulations are to include provisions to prevent a mismatching of exchange gains and losses by taxpayer's switching to the profit and loss method.[162]

Under the version of the profit and loss method adopted under the new law, a U.S. taxpayer must compute the taxable income or loss separately for each QBU in its functional currency and translate such income or loss at the "appropriate exchange rate" for the period. Thus, by contrast to the profit and loss method under prior law, the entire amount of profit or loss of a foreign branch is taken into account at the appropriate exchange rate for the taxable year, without regard to remittances during the year. Under prior law, profit retained by a foreign branch was translated into U.S. dollars at the rate of exchange in effect as of the reporting date, whereas current profits remitted to the home office were translated at the rate of exchange in effect at the date of remittance.[163]

Under new §989(b)(4), the appropriate exchange rate in respect of foreign branch operations is the weighted average exchange rate for the taxable year. A weighted average rate of course has meaning only as it relates to a particular item or items of profit or loss. Congress, unfortunately, has provided no clear guidance with respect to the determination of an appropriate weighted average rate for this purpose.

The House Report provides that "[u]nder regulations, in most cases, the appropriate exchange rate is the weighted average exchange rate for a period (*i.e.*, the rate that would produce approximately the same U.S. dollar amount if each gross receipt were translated on the booking date)." [164] The Senate Report contains no similar language, but does state that, "in most cases, the bill requires the use of weighted average exchange rates (similar to the present law requirements applicable to CFCs)." [165] The Conference Report is silent on this matter.

As noted above, under the §964 translation rules of prior law, a weighted average exchange rate was determined in respect of each item reflected separately on a CFC's financial statements, such as sales and accounts receivable.[166] The translation rules under §964 were often criticized for their rigidity. On the other hand, it seems totally inappropriate to focus solely on gross receipts for purposes of determining a weighted average exchange rate to be used in determining taxable income or loss of a foreign branch. First, "gross receipts" generally is not a meaningful yardstick in the measurement of profit or loss of an accrual basis taxpayer, which recognizes income when earned rather than when received. Moreover, the objective of requiring the use of a weighted average exchange rate for translation purposes was to reflect the fact that net income or loss is realized continuously during a taxable year.[167] A weighted average rate that is developed based solely upon gross receipts may distort net income or loss to the extent that, as typically is the case, expense items do not bear a consistent ratio to gross receipts throughout the

[159] House Report at page 469; Senate Report at 454.

[160] *Id.* This of course assumes that the foreign branch would be in a net current asset position so that a decline in foreign currency relative to the U.S. dollar always would produce an exchange loss.

[161] *Id.* For example, since taxable income or loss was determined by subtracting the ending net worth of a foreign branch from beginning net worth, an unlimited deduction thereby was allowed for capital losses of the branch. Cf. §1211(a).

[162] Conference Report at II-677. There is no elaboration in the Conference Report with respect to the situations in which a "mismatching" of exchange gains and losses might arise upon conversion to a profit and loss method.

[163] The use of a year-end exchange rate tends to distort income for a reporting period, since it does not reflect the fact that profit or loss is realized continuously during the period. The use of a weighted average rate is designed to simulate results produced by a specific transactions method.

[164] House Report at page 477. By comparison, The President's Tax Proposals provided:

> "The average exchange rate for a period is a rate which, if used to translate total gross receipts of an entity during the period, would produce approximately the same dollar amount as would have been obtained had each gross receipt of the entity been translated at the exchange rate for the date the receipt was recorded for tax purposes. A taxpayer would be permitted to use any reasonable procedure, consistently applied, to determine an appropriately weighted exchange rate for the period."

"The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" (May 1985) at 421. The Treasury Discussion Draft on "Taxing Foreign Exchange Gains and Losses" also failed to address this issue specifically. 45 Fed. Reg. 81711 (Dec. 11, 1980).

[165] Senate Report at 454.

[166] Regs. §§1.964-1(d)(2)(i) and (iii).

[167] Senate Report at 454.

year. It appears that guidance from Treasury will be necessary to resolve this matter.

New §987(3) requires that, in determining taxable income of a foreign branch, a U.S. taxpayer make "proper adjustments" (as prescribed by regulations) in respect of "transfers of property between qualified business units of the taxp ing different functional currencies." This broad st was intended to encompass, among other things, possible limitations on the recognition of exchange loss on remittances from a foreign branch to its home office (to prevent selective recognition of exchange losses). It also was contemplated that rules be prescribed for the recognition of gain or loss on contributions of appreciated property to the branch.[168]

In the case of remittances, a U.S. taxpayer is required to recognize exchange gain or loss (without regard to whether remittances are converted into U.S. dollars) to the extent that the value of currency or property at the time of remittance differs from the value when earned (*i.e.*, the applicable weighted average exchange rate used to translate the branch's taxable income or loss). Under new §987(3)(A), post-1986 remittances of foreign branch earnings (and post-1986 interbranch transfers involving branches with different functional currencies) are treated as made on a pro rata basis out of post-1986 accumulated earnings for purposes of determining exchange gains or losses in respect of such remittances or transfers.[169] Moreover, new §987(3)(B) provides that such exchange gains and losses are to be treated as ordinary income or loss and sourced by reference to the source of income giving rise to the post-1986 accumulated earnings. The Conference Report states that the source of such income is generally the residence of the QBU, unless the income of the QBU is derived from U.S. sources.[170] The Conference Report also states that contributions of appreciated property to a QBU may be treated under regulations as a recognition event where appropriate.[171]

Using facts set forth in an example in the Senate Report, the tax consequences of a remittance from a foreign branch may be illustrated as follows:

> *Example:* Assume that a domestic corporation organizes a foreign branch in year one. Assume further that the branch is a qualified business unit, and the branch's functional currency is K.

	Income	Foreign Taxes/ Credit	Exchange Rate
Year 1	100K/$50	23K/$11.50	2K:$1
Year 2	100K/$80	23K/$18.40	1.25K:$1
Year 3	100K/$100	23K/$23	1K:$1

> *Remittance of after-tax earnings in year three.*— Under the bill, the remittance of 231K would trigger $53.90 of exchange gain (attributable to the difference between the current exchange rate (*i.e.*, rate on date of remittance) and the rates in effect for the years in which earned), which is treated as ordinary income:
>
> 1. 77K at 2K:$1 = $38.50 (difference of $38.50).
> 2. 77K at 1.25K:$1 = $61.60 (difference of $15.40).
> 3. 77K at 1K:$1 = $77 (no difference).[172]

Under new §989(c)(5), Treasury is to provide appropriate rules for related party transactions, including transactions between QBUs of the same taxpayer. For example, the Conference Report, at II-675, clarifies that the rule for triggering exchange gain or loss on remittances does not apply to transactions involving the use of related party assets or liabilities, such as the deposit and withdrawal of funds in a branch in the case of a bank. Treasury also is empowered to provide for the recharacterization of interest and principal payments with respect to obligations denominated in certain hyperinflationary currencies.[173]

New §989(c)(2) requires the Treasury to prescribe regulations limiting the recognition of foreign currency losses on certain remittances from QBUs.[174] These regulations specifically are intended to prevent selective recognition of exchange gains and losses by a U.S. taxpayer on remittances from a foreign branch. In addition, the Conference Report indicates that regulations will limit the deduction of losses in respect of a foreign branch using a non-U.S. dollar functional currency to the U.S. taxpayer's U.S. dollar basis in the branch (*i.e.*, original U.S. dollar investment plus subsequent capital contributions and advances, unremitted earnings, and indebtedness for which the taxpayer is liable).[175]

3. *Translation of Earnings and Profits and Distributions of a Foreign Corporation*

a. Prior Law

Under prior law, the rules for translating into U.S. dollars earnings and profits and distributions (actual or deemed) of a foreign corporation that maintained books and records in a foreign currency depended on whether or not the foreign corporation was a "controlled foreign corporation" ("CFC").[176]

[168] *Id.* at 473; Conference Report at II-675.

[169] As noted above, it is not entirely clear at this time how distributions from pre-1987 accumulated earnings will be treated for U.S. tax purposes. If, as it has been suggested, an effort is made to retain the integrity of prior law treatment with respect to such remittances, it may be that exchange gain or loss will be deferred with respect to pre-1987 accumulated earnings until branch operations are terminated.

[170] Conference Report at II-675. In adopting this sourcing rule for exchange gains and losses, the Conference Committee rejected both the separate foreign tax credit limitation approach taken by the House and the U.S. source rule adopted by the Senate.

[171] *Id.*

[172] Senate Report at 471.

[173] §989(c)(3). The Conference Report indicates at II-677, that the conferees specifically desired to curtail the use of tax shelters premised on the creation of debt in a hyperinflationary currency.

[174] *Id.*, at 675.

[175] *Id.*

[176] In either case, earnings and profits of the foreign corporation first had to be converted to a U.S. tax accounting basis before being translated into U.S. dollars.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

In contrast to prior law, tax treatment accorded a U.S. taxpayer in respect of foreign currency transactions entered into through a foreign branch, U.S. shareholders of a foreign subsidiary generally were not required to recognize exchange gains and losses currently for U.S. tax purposes. Instead, except to the extent that the Subpart F provisions of the Code applied (as discussed below), those gains and losses were deferred until realized by the domestic corporation upon the disposition of its interest in the foreign subsidiary.[177] This tax treatment follows generally from the premise that a U.S. corporation and its foreign subsidiary are distinct legal entities and that exchange gains and losses arising from the foreign subsidiary's operations therefore should not be attributed to the U.S. corporation.

Under the so-called "foreign corporation" translation method, earnings and profits and dividends in foreign currency were required to be translated at the exchange rate on the date of the dividend. Thus, to the extent annual profits were distributed currently, the foreign corporation method produced substantially the same results as the profit and loss method applicable to branch operations.

The enactment of Subpart F of the Code (§§951 through 964) significantly reduced the deferral opportunities formerly available to certain U.S. shareholders in respect of their foreign subsidiaries. In this regard, a "U.S. shareholder" of a CFC may be subject to current U.S. tax on some or all of the income earned by the CFC, whether or not such income is distributed currently.[178] The Subpart F provisions thus narrowed the gap between the U.S. tax treatment accorded domestic corporations in respect of their foreign branch versus subsidiary operations.

Primarily for purposes of rationalizing the U.S. tax treatment in respect of foreign branches and CFCs, the Treasury prescribed an accounting method pursuant to which U.S. shareholders of a CFC were required to recognize currently exchange gains and losses in respect of the CFC.[179] A complete analogy could not, however, be drawn to the U.S. tax treatment of foreign branch operations since all the income in respect of a foreign branch is subject to tax currently in the U.S., whereas only certain defined categories of income are subject to current tax under Subpart F. Thus, the net worth method of accounting for foreign branch income, which fails to identify separately operating income and translation gains and losses, could not be adopted on a wholesale basis for Subpart F purposes. Instead, the regime ultimately developed for calculating exchange gain or loss under Subpart F combined characteristics of both the net worth and the profit and loss methods of accounting for foreign branch operations.

In order to isolate the amount of exchange gain or loss in respect of a CFC for any taxable year, total profit or loss (including any exchange gain or loss) first was determined by applying the following basic formula:

Ending retained earnings
Less: Beginning retained earnings
Equals: Total profit or loss.[180]

The amount of retained earnings was determined by translating each balance sheet item into U.S. dollars at appropriate exchange rates so that exchange gains and losses were recognized currently in respect of "financial" assets and "current" liabilities.

The amount of any exchange gain or loss was isolated by subtracting operating profit or loss as translated into U.S. dollars from "total income," as determined pursuant to the above-described rules. In this connection, each profit and loss item was translated into U.S. dollars at an appropriate rate (generally a weighted average rate) to simulate results produced under a specific transactions method.[181]

The amount of any exchange gain or loss increased or decreased the CFC's current earnings and profits for purposes of determining the amount of income subject to current tax under Subpart F. The amount of exchange gain or loss was also allocated between Subpart F income and

[177] Rev. Rul. 75-108, 1975-1 C.B. 69. Although not separately identified, exchange gain or loss was also realized to the extent that the value of foreign currency changed between the date profits were earned and later distributed.

[178] A CFC may be defined generally under post-1986 Act law as a foreign corporation more than 50% of the voting power or value of which is owned by "U.S. shareholders." §957(a). A "U.S. shareholder" is a U.S. person that owns at least 10% of the voting power of the foreign corporation. §951. In general, Subpart F income includes, among other things, certain income from the sales of goods between related persons, certain income from the performance of services for related persons, passive investment income, income from the insurance of non-same country risks, and certain types of foreign shipping and foreign oil-related income. §§952, 953 and 954. (*See also* special rules applicable to "insurance captives" under §953(c).) Income is also passed through under Subpart F where earnings of a CFC are invested in certain U.S. property. §§951, 956.

[179] The Treasury could, of course, have adopted a profit and loss approach for Subpart F purposes. However, at the time Subpart F was enacted, many major foreign currencies had displayed a history of declining in value relative to the U.S. dollar. Thus, use of a translation method that reflected currently exchange losses in respect of working capital was generally advantageous to U.S. taxpayers. The Subpart F translation method was designed to prevent taxation under Subpart F of undistributed income of a CFC in excess of the U.S. dollar earnings and profits available for distribution.

[180] Regs. §1.964-1(e)(2)(i)-(iii). Retained earnings equals assets less the sum of liabilities and paid-in capital. For simplicity, this discussion assumes that no distributions were made during the year.

[181] Regs. §1.964-1(d). Where the foreign currency fluctuated "substantially" within a translation period, each item of profit and loss was required to be translated at a rate representing either the simple average or a weighted average, depending upon which average rate would produce a result more representative of that which would have been produced by translating the individual transactions, reflected in each total amount to be translated, at the closing rate for each month to which such transaction related. The choice between the weighted average and simple average depended mainly upon the extent to which the volume of transactions in any class of items varied from month to month; *i.e.*, the greater the volume varied, the more representative was the weighted average. Whether the degree of currency fluctuation was "substantial" was a facts and circumstances issue depending upon, among other things, the variation in the volume of transactions between months. In general, the degree of fluctuation was considered substantial if the closing rate for any calendar month ending within the translation period varied by more than 10% from the closing rate for any preceding calendar month in such period. The foregoing procedures for translating foreign currency into U.S. dollars were subject to an important qualification. Regs. §1.964-1(d)(7) required that if any transaction involved the payment or receipt of U.S. dollars, or the conversion into or from U.S. dollars, such transaction or conversion had to be reflected in the income statement by the amount of U.S. dollars involved. However, that regulation also provided that no such transaction or conversion was required to be taken into account in U.S. dollars unless the amount of U.S. dollars involved in such transaction or conversion was material.

non-Subpart F income and, to the extent allocable to the former, increased or reduced the amount of income required to be "passed through" and included in gross income currently by the CFC's U.S. shareholders.[182] Accordingly, the results produced under the Subpart F translation method resembled the results under the net worth method, although exchange gains and losses were not separately identified under the net worth method for translating the results of foreign branch operations.

b. Overview of Changes

Section 1261 of the Tax Reform Act of 1986 adds new §§985-989 to the Code, which provisions change prior rules applicable to the translation into U.S. dollars of earnings and profits, and distributions of CFCs and other foreign corporations to coordinate those rules with the new rules adopted for translating into U.S. dollars the operating results of foreign branches. The new provisions are intended to establish approximate U.S. tax parity between domestic corporations operating abroad through foreign subsidiaries and through foreign branches, respectively.

Under new §§986(a) and 989, both a foreign corporation (whether or not a CFC) and a foreign branch using a functional currency other than the U.S. dollar are required to account for and translate their results of operation for U.S. tax purposes under a prescribed variation of the profit and loss method. As a general proposition, unrealized (balance sheet translation) exchange gains and losses of a CFC are no longer to be taken into account. However, under §986(c), exchange gain or loss with respect to distributions of previously taxed earnings (within the meaning of §959) attributable to movements in exchange rates between the date such earnings are included in a U.S. shareholder's income and the date they are actually distributed are to be recognized by the U.S. shareholder and treated as ordinary income or loss from the same source as the associated income inclusion.[183]

c. Reasons for Changes

The Subpart F translation method of prior law closely resembled the net worth translation method applicable to foreign branch operations, and, as discussed at 2, a *supra* (describing U.S. taxation in respect of foreign branches), Congress had a number of concerns regarding the appropriateness of the U.S. tax consequences produced under the net worth method. In addition to those concerns, Congress was troubled by the fact that CFCs enjoyed an implicit election to recognize exchange losses and thereby reduce current Subpart F pass-through exposure and increase current use of the deemed-paid foreign tax credit.[184] In this connection, the notion of providing CFCs with an irrevocable election to choose between the modified net worth and profit and loss methods was considered but expressly rejected. In considering this option, both the House Ways and Means and Senate Finance Committees noted that a taxpayer could use the net worth method in the case of operations in a country with a weak currency (to recognize currently exchange losses) and the profit and loss method for operations in other countries (to defer potential exchange gains).[185]

d. Detailed Analysis

The same accounting and translation rules now generally apply to determine the earnings and profits of a foreign corporation (whether or not a CFC) and the profit and loss of a foreign branch. Under new §§986(a) and 989(b), for purposes of determining the U.S. tax in respect of a foreign corporation, the earnings and profits of the foreign corporation must first be determined in the corporation's functional currency. In the case of a non-CFC, the earnings and profits as so determined are to be translated into U.S. dollars at the current rate of exchange in effect on the date a distribution is included in income. A similar rule is provided in respect of gain from a sale or other disposition of CFC stock that is treated as a dividend under §1248. Thus, contrary to the approach taken in the House bill, no exchange gain or loss is recognized on changes in the U.S. dollar value of the foreign functional currency between the time earnings arise and the time a distribution is included in income.

In the case of a CFC, a deemed distribution of Subpart F income is to be translated pursuant to new 989(b)(3) at the weighted average exchange rate for the CFC's taxable year.[186] Under new §986(c), exchange gain or loss is required to be recognized upon a distribution of previously taxed income to the extent of the change in exchange rates between the date the earnings were included in income of a U.S. shareholder and the date actually distributed. Such gain or loss is treated as ordinary income or loss from the same source as the associated income inclusion.[187] The Treasury is charged with the responsibility of prescribing rules for the treatment of distributions of previously taxed income through tiers of foreign corporations.

Under §1202 of the Tax Reform Act of 1986, amending §902, for purposes of computing the indirect foreign tax credit, treatment of distributions from a foreign corporation as dividends is determined by treating distributions as made from a post-1986 pool of the distributor's earnings and profits. This pooling approach is also to be used to compute

---

[182] Regs. §1.964-1(e)(1). *See* §1.952-1(c)(2)(v).

[183] Although not separately identified, realized exchange gains and losses in respect of non-CFCs will also be reflected, since actual distributions are translated at the current rate of exchange in effect on the date the distribution is made.

[184] In the case of a CFC, a taxpayer in certain circumstances effectively was able to elect to recognize currently foreign exchange losses by structuring transactions of the CFC (*e.g.*, §956 loans to the CFC's U.S. shareholders) to produce current realization of income under Subpart F of the Code. As discussed in a separate section below, the recognition of exchange losses reduces earnings and profits for purposes of the indirect foreign tax credit under §960, thereby artificially increasing the amount of that credit.

[185] House Report at 469; Senate Report at 454. This generally assumes that the foreign branch would be in a net current asset position and therefore would experience exchange losses under the net worth method in the face of a depreciating local currency.

[186] The weighted average exchange rate is also used to translate foreign personal holding company income (§551(a)) and certain amounts included in current income under the new "passive foreign investment company" rules (§1293(a)). As discussed at 2, d *supra*, no clear guidance has been provided regarding the manner in which the weighted average rate is to be derived.

[187] These rules also apply to current income inclusions under the new "foreign passive investment company" rules. *See* §§986(c)(1) and 1293(c).

exchange gain or loss on distributions by a CFC of previously taxed income. As discussed at 2, d *supra*, a pooling approach was also adopted for purposes of determining exchange gain or loss in respect of remittances by foreign branches.[188] Thus, the Act coordinates the taxation of exchange gains and losses in respect of distributions from CFCs and remittances from foreign branches.

Under §1504(d), a domestic corporation may elect to treat certain wholly-owned subsidiaries organized under the laws of Canada or Mexico as domestic corporations, and include such so-called contiguous country corporations in a consolidated tax return. In view of the steady decline in recent times in the value of the currencies of Mexico and Canada relative to the U.S. dollar, this treatment typically resulted in the current recognition of exchange gains and losses under prior law where the net worth method was used to account for contiguous country operations. It was contemplated by the conferees on the Tax Reform Act that the IRS will allow corporations to elect out of §1504(d) status as a result of the statutory repeal of the net worth method of accounting.[189] Any election out from §1504(d) status will generally produce the same tax consequences as under prior law.[190] In addition, "safeguards" are to be provided to limit recognition of exchange losses upon revocation of a §1504(d) election. Further, §243(d) will generally apply to distributions by a contiguous country corporation out of earnings accumulated while a §1504(d) election was in effect. Thus, such a distribution would qualify for the 100% dividends received deduction, provided that a valid §243(b) election is timely made and that no §1562 election was in effect during the year(s) in which the earnings were accumulated.[191]

4. Foreign Tax Credit

Foreign currency translation also affects the direct and indirect foreign tax credit. The focus here is not only on the appropriate exchange rate to be used for purposes of translating foreign taxes in the case of the direct credit, and dividends, earnings and profits, and foreign taxes in the case of the indirect credit, but also on the effects of exchange gain or loss on the foreign tax credit.

a. Prior Law

(1) Direct Foreign Tax Credit

For purposes of the direct foreign tax credit, under prior law cash basis taxpayers were required generally to translate the amount of foreign income taxes paid into U.S. dollars at the rate of exchange for the date of payment, and accrual basis taxpayers were required to use the year-end rate for the year of accrual (or the exchange rate for the date of payment if the taxes were paid in the year accrued).[192] If the amount of foreign taxes accrued differed from the amount paid or if taxes paid later were refunded, the foreign tax credit had to be redetermined in accordance with §905(c). These rules were applied by comparing the U.S. dollar value of taxes accrued and paid. Exchange gain or loss was taken into account in respect of such adjustments to, or refunds of, foreign taxes.[193]

These rules generally applied in respect of foreign taxes paid by U.S. taxpayers in the case of isolated transactions abroad as well as in the case of foreign branch operations.[194]

(2) Indirect Foreign Tax Credit

Dividend distributions to a 10% or greater U.S. shareholder of a foreign corporation generally carry with them a proportionate amount of the foreign taxes paid or accrued by the foreign corporation. In the case of a non-CFC, the indirect foreign tax credit under §902 is determined by multiplying the amount of foreign taxes paid or accrued with respect to the earnings from which a dividend is paid by the ratio of the amount of the dividend to the amount of accumulated profits from which the dividend is paid. Under prior law, each component of the §902 fraction was translated at the exchange rate for the date that the dividend was paid.[195] However, where a foreign corporation kept its books in U.S. dollars, authority existed for translating foreign taxes into U.S. dollars at the rate of exchange as of the date the taxes were paid.[196]

In the case of a CFC, the indirect foreign tax credit under §960 was determined under prior law by multiplying the amount of foreign taxes paid or accrued in respect of earnings to which a Subpart F inclusion related by the ratio of the amount of the Subpart F inclusion to the CFC's current earnings and profits. For purposes of the §960 fraction, the Subpart F inclusion and earnings and profits were translated into U.S. dollars at average rates, as described above in connection with the discussion of the translation of earnings and profits and distributions of CFCs. Thus, the denominator of the §960 fraction, unlike the denominator of the §902 fraction, reflected exchange gain or loss. For this reason, if earnings of a CFC were not passed through fully under Subpart F, when a CFC made an actual distribution, a reconciliation was necessary to determine the amount of the foreign tax credit under §902 attributable to the actual distribution.

b. Overview of Changes

Section 1261 of the Tax Reform Act of 1986 adds new §§985-989 to the Code, which provide a single set of rules for the translation of foreign taxes, and any adjustments thereto or refunds thereof, for foreign tax credit purposes.

[188] As in the case of treatment of remittances from foreign branches, no guidance has been provided with respect to the proper treatment of distributions from pre-1987 earnings and profits.

[189] Conference Report at II-673.

[190] Specifically, in addition to the corporation's being subject to §367(a), the revocation of a §1504(d) election will, among other things, trigger any excess loss accounts (under Regs. §1.1502-19) and the foreign loss recapture rules under §904(f).

[191] Conference Report at II-673.

[192] Rev. Rul. 73-491, 1973-2 C.B. 268. Under §905(a), cash basis taxpayers are allowed to elect to claim a credit for foreign taxes in the year accrued. Cash basis taxpayers making such an election were required to translate foreign taxes under rules applicable to accrual basis taxpayers.

[193] Rev. Rul. 73-506, 1973-2 C.B. 268; Rev. Rul. 58-237, 1958-1 C.B. 534.

[194] However, in certain cases, foreign taxes of a U.S. taxpayer with foreign branch operations accounted for on a profit and loss method were translated for foreign tax credit purposes at the same rate used to translate profits of the branch operations.

[195] Regs. §1.902-1(g)(1); *Bon Ami Co. v. Comr.*, 39 B.T.A. 825 (1939). Foreign tax credits in respect of constructive dividends under §1248 also were determined under §902. Regs. §1.1248-1(d)(1). *See* GCM 37133 (May 24, 1977) concerning a controversy that existed with respect to appropriate exchange rates to be applied to the components of the §902 fraction in that case.

[196] *Commissioner v. American Metal Co.*, 221 F.2d 134 (2d Cir. 1955), cert. denied, 350 U.S. 829.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Under new §986(b)(1)(A), for purposes of determining foreign taxes deemed paid under either §902 or §960, foreign taxes must be translated using the exchange rate for the date the taxes were paid. If foreign taxes paid are later adjusted, new §986(b)(1)(i) requires the adjustment to be translated at the exchange rate in effect as of the adjustment is made. However, pursuant to new §986(b)(1)(B)(ii), any refund of foreign taxes is to be taken into account at the exchange rate in effect as of the date the taxes refunded were originally paid. Under new §987(4), foreign taxes taken into account by a U.S. taxpayer in respect of branch operations are to be translated under these same rules.

Under new §986(a), earnings and profits taken into account for purposes of computing the §960 indirect credit will no longer reflect balance sheet exchange gains and losses.

c. Reasons for Changes

The *Bon Ami* [197] approach to translating components of the §902 fraction under prior law preserved the historic ratio between foreign taxes and accumulated profits. This can be illustrated as follows:

> *Example:* Assume that a French subsidiary corporation has accumulated profits of 400 French francs before French tax and that a French tax of 100 francs was paid. Assume further that the profits were earned, and the tax paid, when the French franc was worth $.20. Thus, a French tax with a value of $20 was paid with respect to $80 of income, resulting in an effective tax rate of 25%. If the earnings are distributed after the franc's value has fallen to $.10, the parent corporation would be deemed to have paid $10 of French tax ($30/$30 x $10). If the franc's value rose to $.25, the parent corporation would be deemed to have paid $25 of French tax ($75/$75 x $25). In either case, the amount of French tax eligible for credit would equal 25% of the U.S.-dollar value of the accumulated profits before tax; however, the U.S.-dollar cost of the French tax paid would be understated or overstated, depending on whether the franc's value depreciated or appreciated.[198]

Thus, the *Bon Ami* approach produced a U.S. tax benefit if foreign functional currency increased in value relative to the U.S. dollar and a disadvantage if the foreign currency decreased in value. This result has been criticized over the years in part because the deemed-paid foreign tax credit is affected by foreign currency fluctuations even after foreign taxes have been paid and tax liability in terms of U.S. dollars fixed.[199] The Tax Reform Act changes bring the foreign tax credit results in respect to a foreign subsidiary corporation more in line with those obtained by U.S. taxpayers operating abroad through a foreign branch.

In the case of the §960 fraction, exchange gain or loss in respect of working capital was taken into account in the determination of earnings and profits. During a year in which a CFC incurred and exchange loss, the denominator of the §960 fraction (earnings and profits) would be reduced, thereby increasing the allowable deemed-paid foreign tax credit relative to the credit that otherwise would have been allowable under §902 had the CFC made an actual distribution equal in amount to the Subpart F inclusion for the year. In this connection, Congress was troubled by the fact that in certain circumstances a U.S. shareholder of a CFC could control whether foreign tax credits would be determined under §902 or §960. This ability to manipulate the indirect credit was, for the most part, limited to CFCs that did not generate Subpart F income in the ordinary course of business and could in their discretion trigger a Subpart F inclusion (and a §960 credit) by, for example, extending a loan to a U.S. shareholder with a term of more than one year.[200]

d. Detailed Analysis

Under new §986(b)(1)(A), for purposes of determining foreign taxes deemed paid under §902 or §960, any foreign income taxes paid by a foreign corporation must be translated into U.S. dollars using the current exchange rate as of the time of *payment*.[201] The U.S. dollar amount of the translated tax is "grossed-up" under §78. Further, under new §986(b)(1)(B), any refund of foreign tax is to be translated into U.S. dollars using the exchange rate as of the time the refunded taxes originally were paid. Any other adjustment of the amount of foreign income taxes paid (*e.g.*, an additional assessment) must be translated at "the appropriate exchange rate as of when such adjustment is made." (Emphasis added.) The Conference Report states that increases in tax are to be translated at the current exchange rate in effect on the date of payment of the additional tax.[202]

The use of date of payment exchange rates for foreign taxes and date of distribution exchange rates for actual distributions and earnings and profits could result in a wide disparity between the effective rate of tax at the time of payment compared to the effective rate of the tax at the time the foreign tax calculation is made. For example, assume a U.K. subsidiary of a domestic corporation pays a U.K. tax of £40 on annual earnings of £100. If the U.K. subsidiary distributes 100% of its earnings as of year-end when the exchange rate is £1:$1.50, the amount of the dividend and earnings and profits as translated into U.S. dollars will be $150 and U.K. tax will be $60, producing a $60 indirect foreign tax credit. Such credit reflects the 40%

[197] Footnote 195 *supra*.
[198] Senate Report at 449.
[199] *See Id.*

[200] §§951(a)(1)(B), 956(b)(1)(C) and (2)(F); Regs. §1.956-2(b).
[201] This rule applies to prepaid taxes (*e.g.*, payment of estimated taxes or withholding taxes) and each installment payment of tax. If a tax is paid by offset against an overpayment in another year, the transaction is split into its component parts for translation purposes, that is, (i) an adjustment of tax for the first year, and (ii) a payment of tax for the second year. House Report at 478.
[202] Conference Report at II-672. It was clear under the House bill that any increases in the amount of foreign tax were to be translated at the exchange rate in effect on the date of adjustment. House Report at 478. After stating that the Conference agreement follows the House bill for purposes of determining the amount of foreign taxes deemed paid under §902 or §960, the Conference Report expressly states: "An increase to foreign taxes is translated on the date of the payment of additional tax." It seems that the conferees intended that the date of payment of additional taxes, rather than the date of adjustment, controls the translation of additional taxes.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

effective U.K. tax rate actually borne by the U.K. subsidiary. However, if the U.K. subsidiary accumulates earnings and pays a dividend when the exchange rate is £1:$3.00, a 100% distribution would yield a dividend and earnings and profits of $300, but the U.K. tax as translated into U.S. dollars would remain $60 as would the indirect foreign tax credit, reflecting an effective tax rate of only 20%.

Under new §987(4), the translation of payments of, and subsequent adjustments to, foreign taxes incurred by a foreign branch is governed by the same rules applicable to the translation of foreign taxes paid by a foreign corporation for purposes of §§902 and 960. The House Report supplies an illustration:

> "Assume a branch pays a tax of 100 Swiss francs in year one. In year two, the branch's tax liability is 50 francs, and the year one tax is adjusted downwards to 60 francs (so there was an overpayment of 40 francs). The 40-franc overpayment from year one is applied against the 50-franc liability for year two. In year three, the 50-franc tax paid in year two is refunded. On these facts, (1) regarding the reduction in the tax paid in year one, the 40 francs are translated at the exchange rate used to translate the tax in year one, and exchange gain or loss (as the case may be) is realized if there is any difference between that exchange rate and the appropriate exchange rate for year two, (2) regarding the crediting of the 40-franc overpayment against the 50-franc tax liability for year two, the entire 50-franc tax is translated at the rate in effect on the date the taxpayer is treated as having paid such tax, and (3) on refund of the year-two 50-franc tax in year three, the refund is translated at the same rate that was used to translate the tax payment in year two, and exchange gain or loss (as the case may be) is realized if there is any difference between that exchange rate and the appropriate exchange rate for year three."[203]

New §989(c)(4) requires the Treasury to prescribe regulations for providing alternative adjustments to the application of §905(c). For example, the Conference Report states that as opposed to any redetermination of taxes required by 905(c), the Treasury may provide for the adjustment of a dollar-based pool of taxes.[204]

---

[203] House Report at page 480.

[204] Conference Report at 676. Section 989 is generally effective for taxable years beginning after 1986. Act §1261(e).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Addendum to Chapter 60

INTERNAL REVENUE SERVICE'S ADVANCE NOTICE 87-11, ON CERTAIN FULLY HEDGED FOREIGN CURRENCY TRANSACTIONS, RELEASED DEC. 31, 1986 (TEXT)

Part III - Administrative, Procedural, and Miscellaneous

Guidance Is Provided Under Section 988(d) of the Internal Revenue Code With Respect To Certain Fully Hedged Foreign Currency Transactions

Notice 87-11

SECTION 1. INTRODUCTION

The Internal Revenue Service announces that it will issue regulations under section 988(d) of the Internal Revenue Code regarding certain fully hedged foreign currency transactions. Section 988(d) provides that to the extent provided in regulations, if any section 988 transaction is part of a 988 hedging transaction, all transactions which are part of such 988 hedging transaction shall be integrated and treated as a single transaction or otherwise treated consistently. The regulations to be issued will set forth the consequences of integrating and treating as a single transaction all transactions that comprise a fully hedged section 988 hedging transaction that is an integrated economic package. The regulations generally will follow the provisions of sections 2 through 6 of this notice and will integrate a section 988 hedging transaction only with respect to the taxpayer that enters into the transaction. Until such regulations are issued, taxpayers may rely on this notice with respect to transactions entered into after December 31, 1986, that occur in taxable years beginning after December 31, 1986.

SECTION 2. TRANSACTIONS TO WHICH THIS NOTICE APPLIES

(a) *Qualified Hedging Transaction - (1) In General.* This notice applies only to qualified hedging transactions as defined in this section 2. A qualified hedging transaction is an integrated economic package, as provided in paragraph (d) of this section, consisting of a qualifying transaction, as defined in paragraph (b) of this section, and a section 988 hedge, as defined in paragraph (c) of this section, provided that--

(i) the interest rate (fixed or floating) on the qualifying transaction is set and all exchange rates on the section 988 hedge are fixed on the same calendar day (the trade date, as defined in paragraph (e)(7) of this section) such that the cost or return with respect to such qualified hedging transaction is not affected by movements in exchange rates after the trade date, and

(ii) all transactions that comprise the qualified hedging transaction are entered into on or before the settlement date (as defined in paragraph (e)(8) of this section).

(2) *Exceptions.* This notice shall not apply with respect to--

(i) A qualified hedging transaction that creates a synthetic asset or liability denominated in a currency other than the dollar if the rate that approximates the Federal short-term rate in such currency is at least 20 percentage points higher that the Federal short-term rate (determined under section 1274(d)) on the trade date, or

(ii) A transaction that would be a qualified hedging transaction but for the fact that a component transaction is terminated prior to maturity.

(3) *Service solicits comments.* The Service solicits comments on the application of section 988(d) under the rules prescribed in this notice. The Service also solicits comments as to the possible application of section 988(d) to transactions not described in this notice, including:

(i) Transactions in which the interest rate with respect to the qualifying transaction is set and the exchange rates with respect to the hedge are fixed on different calendar days,

(ii) Transactions in which either the hedge or the qualifying transaction is terminated prior to maturity,

(iii) Transactions that are partially hedged.

(b) *Qualifying transaction - (1) Definition.* A qualifying transaction is a borrowing under a debt instrument or the purchase of a debt instrument if the entire amount which the taxpayer (or qualified business unit of the taxpayer) is required to pay or is entitled to receive as a result of the transaction--

(i) Is denominated in terms of a functional currency, or

(ii) Is denominated in terms of a nonfunctional currency.

(2) *Exceptions.* A qualifying transaction does not include a borrowing under a debt instrument or the purchase of a debt instrument if the payment or receipt of interest and principal is denominated in more than one currency.

(c) *Definition of a section 988 hedge.* A section 988 hedge (hereinafter referred to as a "hedge") is a spot contract, a swap agreement or agreements, forward contract, series of

forward contracts or combination thereof that fixes the cost or return with respect to a qualifying transaction (or transactions) in terms of a currency other than the currency in which such qualifying transaction is denominated such that the cost or return is not affected by movements in exchange rates after the trade date (as defined in section 2(e)(7) of this notice).

(d) *Definition of integrated economic package.* (1) *In general.* For purposes of this notice, a qualifying transaction and a hedge are an integrated economic package if--

(i) The qualifying transaction and the hedge are a package as defined in paragraph (d)(2) of this section, and

(ii) The qualifying transaction and the hedge make up one of the economically integrated transactions enumerated in paragraph (d)(3) of this section.

(2) *Definition of a package.* A qualifying transaction and a hedge are a package if all the requirements of this section 2(d)(2) are satisfied as follows--

(i) The interest rate (fixed or floating) on a qualifying transaction that is a borrowing under a debt instrument or the rate of return (fixed or floating) on a qualifying transaction that is the purchase of a debt instrument is set, and the exchange rates on the hedge are fixed, on the trade date.

(ii) None of the parties to the qualifying transaction or hedge are related as defined in section 2(e)(4) of this notice.

(iii) The identification requirements of section 3 of this notice are satisfied.

(iv) Except with respect to a transaction described in section 2(d)(3)(vi), the total initial amount borrowed under a debt instrument or the total initial amount paid to acquire a debt instrument that is the qualifying transaction is hedged at an exchange rate determined on the trade date.

(v) All subsequent interest and principal amounts paid with respect to a qualifying transaction that is a borrowing or all subsequent interest and principal amounts received with respect to a qualifying transaction that is the purchase of a debt instrument are hedged throughout the term of the qualifying transaction at an exchange rate determined on the trade date.

(vi) The qualifying transaction matures on the same day the hedge expires. (A hedge expires on the last day a payment is made or received under the terms of the hedge.)

(vii) In the case of a qualified business unit with a residence, as defined in section 988(a)(3)(B) of the Code, outside of the United States, or a qualified business unit resident in the United States with a functional currency other than the dollar, both the qualifying transaction and the hedge are entered into by the same qualified business unit and the interest income or expense from the qualified hedging transaction is properly reflected on the books of such qualified business unit throughout the term of the qualified hedging transaction.

(viii) Subject to the limitations of section 2(d)(2)(vii) of this notice, both the qualifying transaction and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the qualifying transaction and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return.

(ix) With respect to a foreign person engaged in a U.S. trade or business that enters into a qualifying transaction or hedge through such trade or business, all items of income and expense associated with the qualifying transaction and the hedge, would have been effectively connected with such U.S. trade or business throughout the term of the qualified hedging transaction had the provisions of this notice not applied.

(3) *Economically integrated transactions.* A qualifying transaction and a hedge are economically integrated if--

(i) The hedge effectively converts a qualifying transaction that is a nonfunctional currency borrowing into a functional currency borrowing. A nonfunctional currency borrowing is effectively converted into a functional currency borrowing if--

(A) The entire principal amount of nonfunctional currency received from the borrowing is sold or exchanged for functional currency on the settlement date at a rate fixed on the trade date, and

(B) The terms of the hedge provide for the acquisition of the borrowed nonfunctional currency, in exchange for functional currency, on the calendar day when interest and principal payments are due on the borrowing and in an amount which equals such interest and principal payments.

(ii) The hedge effectively converts a qualifying transaction that is a borrowing in one nonfunctional currency (first nonfunctional currency) into a borrowing in a second nonfunctional currency. A borrowing in one nonfunctional currency is effectively converted into a borrowing in a second nonfunctional currency if —

(A) The entire principal amount of the first nonfunctional currency received from the borrowing is sold or exchanged for a second nonfunctional currency on the settlement date at a rate fixed on the trade date, and

(B) The terms of the hedge provide for the acquisition of the borrowed nonfunctional currency (i.e., the first nonfunctional currency), in exchange for the second nonfunctional currency, on the calendar day when interest and principal payments are due on the borrowing and in an amount which equals such interest and principal payments.

(iii) The hedge effectively converts a qualifying transaction that is a functional currency borrowing into a nonfunctional currency borrowing. A functional cur-

rency borrowing is effectively converted into a nonfunctional currency borrowing if--

(A) The entire principal amount of functional currency received from the borrowing is sold or exchanged for nonfunctional currency on the settlement date at a rate fixed on the trade date, and

(B) The terms of the hedge provide for the acquisition of the borrowed functional currency, in exchange for that nonfunctional currency on the calendar day when interest and principal payments are due on the borrowing and in an amount which equals such interest and principal payments.

(iv) The hedge effectively converts a qualifying transaction that is the purchase of a nonfunctional currency denominated debt instrument into a functional currency denominated debt instrument. The purchase of a nonfunctional currency denominated debt instrument is effectively converted into the purchase of a functional currency denominated debt instrument if--

(A) In exchange for functional currency, the purchaser acquires on the trade date (at a rate set on such date), for delivery on the settlement date, an amount of nonfunctional currency equal to the purchase price of the debt instrument and exchanges such nonfunctional currency for the debt instrument on the settlement date, and

(B) The terms of the hedge provide for the sale or exchange of the nonfunctional currency denominated interest and principal payments received under the debt instrument for functional currency, at a rate fixed on the trade date, on the calendar day when such payments are received.

(v) The hedge effectively converts a qualifying transaction that is the purchase of a debt instrument denominated in one nonfunctional currency into the purchase of a debt instrument denominated in a second nonfunctional currency. The purchase of a debt instrument denominated in one nonfunctional currency (first nonfunctional currency) is effectively converted into a debt instrument denominated in a second nonfunctional currency if--

(A) In exchange for functional currency, the purchaser acquires on the trade date (at a rate set on such date), for delivery on the settlement date, an amount of the first nonfunctional currency equal to the purchase price of the debt instrument and exchanges that nonfunctional currency for the debt instrument on the settlement date, and

(B) The terms of the hedge provide for the exchange of the first nonfunctional currency denominated interest and principal payments received under the debt instrument for a second nonfunctional currency, at a rate fixed on the trade date, on the calendar day such payments are received.

(vi) The hedge effectively converts a qualifying transaction that is the purchase of a functional currency denominated debt instrument into a nonfunctional currency denominated debt instrument. The purchase of a functional currency denominated debt instrument is effectively converted into the purchase of a nonfunctional currency denominated debt instrument if--

(A) The purchaser acquires the functional currency denominated debt instrument for functional currency, and

(B) The terms of the hedge provide for the sale or exchange of the functional currency denominated interest and principal payments received under the debt instrument for nonfunctional currency, at a rate fixed on the trade date, on the calendar day when such payments are received.

(e) *Other definitions.*

(1) *Functional currency.* For the definition of functional currency, see section 985 of the Code.

(2) *Nonfunctional currency.* A nonfunctional currency is any currency other than a functional currency.

(3) *Qualified business unit.* For the definition of qualified business unit, see section 989 (a) of the Code.

(4) *Related.* The term "related" means the relationships defined in section 267(b) and section 707(b)(1) of the Code.

(5) *Swap Agreement.* A contract in which two parties agree to exchange simultaneously one currency for another at a predetermined rate, in which each party's obligation to perform is contingent upon the other party's performance.

(6) *Spot contract.* A contract for the purchase or sale of currency which requires delivery in two business days or less.

(7) *Trade date.* The one calendar day on which both —

(i) The interest rate (fixed or floating) on a qualifying transaction that is a borrowing under a debt instrument or the rate of return (fixed or floating) on a qualifying transaction that is the purchase of a debt instrument is set, and

(ii) All exchange rates on the hedge are fixed.

(8) *Settlement date.* The first calendar day on which--

(i) With respect to a qualifying transaction that is a borrowing, proceeds of the borrowing are credited to the taxpayer's account, otherwise made available so that the taxpayer may draw upon such proceeds at any time, or actually received by the taxpayer, or

(ii) With respect to a qualifying transaction that is the purchase of a debt instrument, the debt instrument is available for delivery to the taxpayer or is credited to the taxpayer's account.

(9) *Debt Instrument.* The term debt instrument means a bond, debenture, note, certificate or similar financial instrument but does not include–

(i) Accounts payable, accounts receivable or similar items of expense or income, or

(ii) A debt instrument issued as part of a transaction subject to sections 483 or 1274 of the Code. For

purposes of applying sections 483 and 1274, currency (functional or nonfunctional) shall not be considered property.

(10) *Purchase.* The term purchase includes an extension of credit.

SECTION 3. IDENTIFICATION REQUIREMENTS

(a) *In general.* In order to satisfy the identification requirements of this section, a taxpayer must:

(1) Identify a qualified hedging transaction on its books and records in accordance with paragraph (b) of this section before the close of the trade date, and

(2) Verify in accordance with paragraph (c) of this section that the interest rate on the qualifying transaction was set and the exchange rates on the hedge were fixed on the trade date.

In the case of an individual, the close of the trade date is midnight (local time) in the location of the individual's principal residence. In the case of any qualified business unit of a taxpayer, the close of the trade date is midnight (local time) in the location of such unit's principal place of business.

(b) *Identification on books and records of the taxpayer or qualified business unit.* A taxpayer, or qualified business unit of a taxpayer, must establish a separate account on its books and records designated "Qualified Hedging Account." Before the close of the trade date, such person must enter into the account--

(1) A description of the qualifying transaction including the interest rate and the date such rate was set,

(2) A description of all elements of the hedge including the exchange rates and the date such exchange rates were fixed, and

(3) A summary of the cash flows resulting from the qualified hedging transaction.

(c) *Verification that the interest rate was set and the exchange rates were fixed on the same day--*

(1) *Presumption.* A taxpayer is presumed to have verified that the interest rate on the qualifying transaction was set and the exchange rates on the hedge were fixed on the trade date if the taxpayer receives independent verification as defined in paragraph (c)(3) of this section from one or more persons with respect to all of the information identified on its books and records pursuant to paragraph (b) of this section.

(2) *Corroborating evidence.* If the presumption of paragraph (c)(1) of this section does not apply, the burden shall be on the taxpayer to establish that the interest rate on the qualifying transaction was set and the exchange rates on the hedge were fixed on the trade date. If the taxpayer fails to provide evidence other than the information entered on its books and records in accordance with paragraph (b) of this section and its own testimony, the identification requirements of this section shall not be satisfied unless the taxpayer shows good cause for such failure.

(3) *Independent verification.* Independent verification means:

(i) A written confirmation received from the person or persons (including an underwriter in a firm commitment underwriting) with respect to whom the qualifying transaction or the hedge is entered into, or

(ii) A written contract (*e.g.* a swap contract) signed and dated by the parties to the transaction.

(d) *Identification by the Commissioner.* If--

(1) A person enters into a qualifying transaction and a hedge but fails to comply with one or more of the requirements of sections 2 and 3 of this announcement, and

(2) On the basis of all the facts and circumstances, the Commissioner concludes that the qualifying transaction and the hedge are, in substance, a qualified hedging transaction,

then the Commissioner may treat the qualifying transaction and the hedge as a qualified hedging transaction for all purposes of this notice. The Commissioner may identify a qualifying transaction and a hedge as a qualified hedging transaction even though the qualifying transaction and the hedge are entered into by different related corporations (as defined in section 2(e)(4) of this notice), or by a domestic corporation and a qualified business unit with a residence outside the United States. With respect to a qualifying transaction and a hedge that are treated by the Commissioner as a qualified hedging transaction under this section 3(d), the qualifying transaction and the hedge each remain, at the discretion of the Commissioner, subject to the rules of sections 1092 and 263(g).

SECTION 4. TAXATION OF QUALIFIED HEDGING TRANSACTIONS

(a) *In general — (1) General rule.* If a transaction constitutes a qualified hedging transaction as defined in section 2 of this announcement, the qualifying transaction and the hedge are integrated and treated as a single transaction with respect to the taxpayer that has entered into the qualified hedging transaction. Except as provided in section 3(d) of this notice, neither the qualifying transaction nor the hedge that make up the qualified hedging transaction shall be subject to section 263(g) 1092 or 1256.

(2) *Special rule for income or expense of foreign persons effectively connected with a U.S. trade or business.* Interest income of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of section 2(d)(2)(ix) of this notice shall be treated as effectively connected with a U.S. trade or business. Interest expense of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of section 2(d)(2)(ix) of this notice shall be allocated and apportioned under section 1.882-5 of the regulations.

(3) *Special rule for foreign persons that enter into qualified hedging transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business.* If a foreign person enters into a qualified hedging transaction that gives rise to U.S. source interest income (determined under the source rules for synthetic asset transactions as provided in this section) not effectively connected with a U.S. trade or business of such foreign persons, for purposes of sections 871(a), 881, 1441, 1442 and 6049, the provisions of this notice shall not apply and such sections of the Code shall be applied separately to the qualifying transaction and the hedge. To the extent relevant to any foreign person, if the requirements of this notice are otherwise met, the provisions of this notice shall apply for all other purposes of the Code (*e.g.*, for purposes of calculating the earnings and profits of a controlled foreign corporation that enters into a qualified hedging transaction through a qualified business unit resident outside the United States, income or expense with respect to such qualified hedging transaction shall be calculated under the provisions of this notice).

(b) *Income tax effects of integration.* The income tax effects of integrating and treating a transaction as a single transaction are determined under paragraphs 1 through 6 of this section 4(b).

(1) *Qualified hedging transaction that effectively converts a nonfunctional currency borrowing into a functional currency borrowing.* The income tax effects of integrating a qualified hedging transaction described in section 2(d)(3)(i) of this notice are as follows —

(i) *Deemed functional currency borrowing.* The integration of the nonfunctional currency denominated borrowing and the hedge results in a deemed functional currency borrowing with respect to the borrower. The amount deemed to be borrowed equals the total amount of functional currency received under the terms of the hedge in exchange for the total amount of the nonfunctional currency-borrowed. The total amount of interest and principal deemed to be paid equals the total amount of functional currency paid under the terms of the hedge to acquire the nonfunctional currency necessary to make interest and principal payments on the nonfunctional currency borrowing.

(ii) *Determination of interest expense of the borrower.* The interest expense deductible by the borrower shall be determined as follows--

(A) The issue price and stated redemption price at maturity of the deemed functional currency borrowing shall be determined under the provisions of section 1273 and the regulations thereunder in units of the functional currency.

(B) If the deemed functional currency borrowing has original issue discount (OID) within the meaning of section 1273(a)(1), then the rules of section 163(e) and the regulations thereunder shall govern the manner in which such discount is deductible by the borrower.

(C) Any interest expense other than OID with respect to the deemed functional currency borrowing shall be deductible from gross income under section 163(a) (subject to any limitations on deductibility contained in other sections of the Code) in accordance with the borrower's regular method of accounting.

(iii) *Allocation and apportionment of interest expense.* The interest expense determined pursuant section 4(b)(1)(ii) of this notice shall be allocated and apportioned under sections 1.861-8 and 1.882-5 of the regulations as the case may be (subject to section 864(e) of the Code).

(2) *Qualified hedging transaction that effectively converts a borrowing in one nonfunctional currency into a borrowing in a second nonfunctional currency.* The income tax effects of integrating a qualified hedging transaction described in section 2(d)(3)(ii) of this notice are as follows-

(i) *Deemed borrowing in the second nonfunctional currency.* The integration of the nonfunctional currency borrowing (i.e., first nonfunctional currency) and the hedge results in a deemed borrowing in the second nonfunctional currency. The amount deemed to be borrowed equals the total amount of the second nonfunctional currency received under the terms of the hedge in exchange for the total amount of the first nonfunctional currency borrowed. The total amount of interest and principal deemed to be paid equals the total amount of the second nonfunctional currency paid under the terms of the hedge to acquire the first nonfunctional currency necessary to make interest and principal payments on the first nonfunctional currency borrowing.

(ii) *Determination of interest expense of the borrower.* The interest expense deductible by the borrower shall be determined as follows--

(A) The issue price and stated redemption price at maturity of the deemed borrowing in the second nonfunctional currency shall be determined by applying the provisions of section 1273 and the regulations thereunder directly to the units of the second nonfunctional currency used to make the interest and principal payments under the deemed borrowing.

(B) If the deemed borrowing in the second nonfunctional currency has original issue discount (OID) within the meaning of section 1273(a)(1), then the rules of section 163(e) and the regulations thereunder shall govern the manner in which the amount of such discount denominated in units of the second nonfunctional currency is determined. The amount of discount deductible by the borrower in his functional currency shall be the amount determined in the manner described in the preceding sentence, translated into the borrower's functional currency using the weighted average exchange rate for the accrual period. Any amounts of qualified periodic interest (as defined in § 1.1273-1(b)(1)(ii) of the proposed regulations) shall be translated into the borrower's functional currency at the spot rate on the date of payment and deduct-

ed from gross income in accordance with the borrower's regular method of accounting.

(C) Any interest expense other than OID with respect to the deemed second nonfunctional currency borrowing shall be determined under section 163(a) in units of the second nonfunctional currency (subject to any limitations on deductibility contained in other sections of the Code). The interest expense deductible by the borrower in his functional currency shall be the amount determined in the manner described in the preceding sentence, translated into the borrower's functional currency at the spot rate on the date of payment and deducted in accordance with the taxpayer's regular method of accounting.

(iii) *Allocation and apportionment.* The interest expense determined pursuant to section 4(b)(2)(ii) of this notice shall be allocated and apportioned under sections 1.861-8 and 1.882-5 of the regulations as the case may be (subject to the section 864(e)).

(iv) *Deemed borrowing in the second nonfunctional currency is a position under section 1092.* The deemed borrowing in the second nonfunctional currency referred to in this section (4)(b)(2) is a position as defined in section 1092 (d)(2).

(3) *Qualified hedging transaction that effectively converts a functional currency borrowing into a nonfunctional currency borrowing.* The income tax effects of integrating a qualified hedging transaction described in section 2(d)(3)(iii) of this notice are as follows--

(i) *Deemed nonfunctional currency borrowing.* The integration of the functional currency borrowing and the hedge results in a deemed nonfunctional currency borrowing. The amount deemed to be borrowed equals the total amount of nonfunctional currency received under the terms of the hedge in exchange for the total amount of functional currency borrowed. The total amount of interest and principal deemed to be paid equals the total amount of nonfunctional currency paid under the terms of the hedge to acquire the functional currency necessary to make interest and principal payments on the functional currency borrowing.

(ii) *Determination of interest expense of the borrower.* Interest expense deductible by the borrower shall be determined in the manner described in section 4(b)(2)(ii) of this notice by substituting the phrase "nonfunctional currency" for the phrase "second nonfunctional currency."

(iii) *Allocation and apportionment.* The interest expense determined pursuant to section 4(b)(3)(ii) of this notice shall be allocated and apportioned under sections 1.861-8 or 1.882-5 of the regulations as the case may be (subject to section 864(e)).

(iv) *Deemed nonfunctional currency borrowing is a position under section 1092.* The deemed nonfunctional currency borrowing referred to in this section 4(b)(3) is a position as defined in section 1092 (d)(2).

(4) *Qualified hedging transaction that effectively converts the purchase of a nonfunctional currency denominated debt instrument into a functional currency denominated debt instrument.* The income tax effects of integrating a qualified hedging transaction described in section 2(d)(3)(iv) of this notice are as follows--

(i) Deemed functional currency denominated debt *instrument.* The integration of the nonfunctional currency denominated debt instrument and the hedge results in a deemed functional currency denominated debt instrument with respect to the holder. The purchase price of the deemed functional currency denominated debt instrument is the amount of the functional currency paid to acquire the nonfunctional currency used for the purchase of the nonfunctional currency denominated debt instrument. The total amount of interest and principal deemed received by the holder equals the total amount of functional currency received under the terms of the hedge in exchange for the nonfunctional currency interest and principal payments received pursuant to the terms of the nonfunctional currency denominated debt instrument.

(ii) *Determination of interest income.* The interest income of the holder shall be determined as follows--

(A) The issue price and stated redemption price at maturity of the deemed functional currency denominated debt instrument shall be determined under section 1273 and the regulations thereunder in units of the functional currency.

(B) If the deemed functional currency denominated debt instrument has OID, then the interest income includible by the holder shall be determined pursuant to the provisions of section 1272 and the regulations thereunder.

(C) If the deemed functional currency denominated debt instrument does not have OID, then the interest shall be includible in gross income under section 61 in accordance with the holder's regular method of accounting.

(iii) *Source.* The source of the deemed interest income shall be determined by reference to the source, as determined under sections 861(a)(1) and 862(a)(1), of the interest income that would have been received under the terms of the qualifying transaction had such transaction not been integrated pursuant to sections 2 and 4 of this notice.

(5) *Qualified hedging transaction that effectively converts the purchase of a debt instrument denominated in one nonfunctional currency into the purchase of a debt instrument denominated in a second nonfunctional currency.* The income tax effects of integrating a qualified hedging transaction described in section 2(d)(3)(v) of this notice are as follows--

(i) *Deemed purchase of a debt instrument denominated in the second nonfunctional currency.* The integration of the debt instrument denominated in the first nonfunctional currency and the hedge results in a deemed debt instrument denominated in the second nonfunctional currency (referred to as deemed second nonfunctional currency debt instrument) with respect to the holder. The purchase price of the deemed second

nonfunctional currency denominated debt instrument is the amount of the first nonfunctional currency used to purchase the first nonfunctional currency denominated debt instrument on the settlement date translated into the second nonfunctional currency at the forward exchange rate between the two currencies (as determined on the trade date) with respect to the period between the trade date and the settlement date. The total amount of interest and principal received by the holder of the deemed second nonfunctional currency denominated debt instrument equals the total amount of the second nonfunctional currency received under the hedge in exchange for the first nonfunctional currency interest and principal payments.

(ii) *Determination of interest income.* The interest income of the holder shall be determined as follows--

(A) The issue price and stated redemption price at maturity of the deemed second nonfunctional currency denominated debt instrument shall be determined by applying the provisions of section 1273 and the regulations thereunder directly to the units of the second nonfunctional currency to be received in exchange for the interest and principal payments to be received under the debt instrument.

(B) If the deemed second nonfunctional currency denominated debt instrument has OID, then the rules of section 1272 and the regulations thereunder shall govern the manner in which the amount of such discount denominated in units of the second nonfunctional currency is determined. The amount of discount includible by the holder in his functional currency under section 1272 shall be the amount determined in the manner described in the preceding sentence, translated into the holder's functional currency at the weighted average exchange rate for the accrual period. Any amounts of qualified periodic interest (as defined in §1.1273-1(b)(1)(ii) of the proposed regulations) shall be translated into the holder's functional currency at the spot rate on the date of payment and included in gross income in accordance with the holder's regular method of accounting.

(C) Any interest income other than OID with respect to the deemed second nonfunctional currency denominated debt instrument shall be determined in units of the second nonfunctional currency. The interest income includible by the holder in his functional currency shall be the amount determined in the manner described in the preceding sentence, translated into the holder's functional currency at the spot rate on the date of payment.

(iii) *Source.* The source of the deemed interest income shall be determined by reference to the source, as determined under section 861(a)(1) and 862(a)(1), of the interest income that would have been received under the terms of the qualifying transaction had such transaction not been integrated pursuant to sections 2 and 4 of this notice.

(iv) *Deemed debt instrument is a position under section 1092.* The deemed debt instrument referred to in this section 4(b)(5) is a position as defined in section 1092 (d)(2).

(6) *Qualified hedging transaction that effectively converts the purchase of a functional currency denominated debt instrument into a nonfunctional currency denominated debt instrument.* The income tax effects of integrating a qualified hedging transaction described in section 2(d)(3)(vi) of this notice are as follows--

(i) *Deemed purchase of a nonfunctional currency denominated debt instrument.* The integration of the functional currency denominated debt instrument and the hedge results in a deemed nonfunctional currency denominated debt instrument. The purchase price of the deemed nonfunctional currency denominated debt instrument is the amount of functional currency used to purchase the functional currency denominated debt instrument on the settlement date translated into nonfunctional currency at the forward exchange rate between the two currencies (as determined on the trade date) with respect to the period between the trade date and the settlement date. The total amount of interest and principal received by the holder equals the total amount of nonfunctional currency received under the terms of the hedge in exchange for the functional currency interest and principal payments.

(ii) *Determination of interest income.* Interest income shall be determined in the manner described in section 4(b)(5)(ii) of this notice by substituting the phrase "nonfunctional currency" for the phrase "second nonfunctional currency."

(iii) *Source.* The source of the deemed interest income shall be determined by reference to the source, as determined under sections 861(a)(1) and 862(a)(1), of the interest income that would have been received under the terms of the qualifying transaction had such transaction not been integrated pursuant to sections 2 and 4 of this notice.

(iv) *Deemed nonfunctional currency debt instrument is a position under section 1092.* The deemed nonfunctional currency debt instrument referred to in this section 4(b)(6) is a position as defined in section 1092 (d).

(c) *Examples.*

Example (1). Synthetic functional currency liability (nonfunctional currency borrowing hedged with a swap). X, a U.S. corporation, has currency A as its functional currency. (The term "currency A" is used to designate a functional currency which, subject to the limitations of section 985, can be the United States dollar or any other currency.) On December 24, 1987 (the trade date), X agrees to close the following transaction on December 31, 1987 (settlement date). X will borrow from an unrelated party on December 31, 1987, 100 units of currency B for 3 years at a 10 percent rate of interest, payable annually, with no principal payment due until the final installment. x will also enter into a swap agreement with an unrelated counterparty under the terms of which - - (1) X will swap, on December

31, 1987, the 100 units of currency B obtained from the borrowing for 100 units of currency A, and (2) X will exchange currency A for currency B pursuant to the following table in order to obtain the units of currency B necessary to make payments on the currency B borrowing:

DATE	CURRENCY A	CURRENCY B
December 31, 1988	8	10
December 31, 1989	8	10
December 31, 1990	108	110

The interest rate on the borrowing is set and the exchange rates on the swap are fixed on December 24, 1987.

On December 31, 1987, X borrows the 100 currency B units and swaps such units for 100 currency A units. Assume X has satisfied the identification and verification requirements of section 3 of this notice.

The currency B borrowing (which constitutes a qualifying transaction under section 2(b) of this announcement) and the swap agreement (which constitutes a hedge under section 2(c)) are a qualified hedging transaction as defined in section 2(a). Accordingly, the currency B borrowing and the swap are integrated and treated as one transaction with the following consequences: (1) The integration of the currency B borrowing and the swap results in a deemed currency A borrowing in an amount equal to the 100 currency A units received on December 31, 1987 in exchange for the 100 units of currency B. Accordingly, the issue price under section 1273(b)(2) is 100 currency A units. (2) The total amount of interest and principal paid by X with respect to the deemed currency A borrowing is equal to the currency A payments made by X under the swap agreement (i.e., 8 currency A units in 1988, 8 currency A units in 1989 and 108 currency A units in 1990). (3) The stated redemption price at maturity (defined in section 1273(a)(2) and § 1.1273-1(b)(1) of the proposed regulations as the amount payable at maturity other than a payment of qualified periodic interest) is 100 currency A units. Since the stated redemption price equals the issue price, there is no OID on the deemed currency A borrowing. (4) X may deduct the annual interest payments of 8 currency A units under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. X has also paid 100 currency A units as a return of principal in 1990. (5) X must allocate and apportion its interest expense under section 1.861-8 of the regulations (subject to section 864(e) of the Code).

Example (2). Synthetic functional currency liability (nonfunctional currency borrowing hedged with forward contracts) — higher interest rate currency. X, a U.S. corporation, has currency A as its functional currency. (The term "currency A" is used to designate a functional currency which, subject to the limitations of section 985, can be the United States dollar or any other currency.) On December 24, 1987 (the trade date), when the spot rate is one unit of currency A equals one unit of currency B, X agrees to close the following transaction on December 31, 1987 (settlement date). X will borrow 100 units of currency B from an unrelated party on December 31, 1987 for three years at 10 percent interest, payable annually, with no principal payment due until the final installment. X also enters into a series of contracts with a bank to: (1) sell forward the 100 units of currency B for 99.96 units of currency A on December 31, 1987, and (2) buy forward for currency A, the amount of currency B required to make the interest and principal payments due under the currency B borrowing according to the following schedule:

DATE	CURRENCY A	CURRENCY B
December 31, 1988	9.81	10
December 31, 1989	9.64	10
December 31, 1990	104.07	110

The interest rate on the borrowing is set and the exchange rates on the forward contracts are fixed on December 24, 1987.

On December 31, 1987, X borrows 100 currency B units end exchanges such units for 99.96 currency A unite. Assume X satisfies the identification and verification requirements of section 3 of this notice.

The currency B borrowing (which constitutes a qualifying transaction under section 2(b) of this announcement) and the series of forward contracts (which constitute a hedge under section 2(c)) are a qualified hedging transaction under section 2(a). Accordingly, the currency B borrowing and the forward contracts are integrated and treated as one transaction with the following consequences: (1) The integration of the currency B borrowing and the forward contracts results in a deemed currency A borrowing in an amount equal to the 99.96 currency A units received on December 31, 1987 for the 100 units of borrowed currency B. Accordingly, the issue price under section 1273 (b)(2) is 99.96 currency A units. (2) The total amount of interest and principal paid by X with respect to the deemed currency A borrowing is equal to the currency A payments made by X under the forward purchase contracts (i.e., 9.81 currency A units in 1988, 9.64 currency A units in 1989 and 104.07 currency A units in 1990). (3) The deemed currency A borrowing is an installment obligation within the meaning of section 1.1273-1(b)(2)(i) of the proposed regulations and its stated redemption price at maturity (defined in section 1273(a)(2) and § 1.12731(b)(2)(ii) of the proposed regulations as the sum of all payments to be made under the borrowing other than qualified periodic interest) is 99.96 currency A units (i.e., under § 1.1273-1(b)(1)(ii), 8.00 units of the currency A payment in 1988, 7.86 units of the currency A payment in 1989, and 7.71 units of the currency A payment in 1990 are treated as qualified periodic interest payments). Since the stated redemption price at maturity is equal to the issue price, under section 1273(a)(1) there is no OID on the deemed currency A borrowing. (3) The yield to maturity (as defined in § 1.1272-1(f) of the proposed regulations) of the deemed currency A borrowing is 8.00 percent, compounded annually. (4) Therefore, assuming X is a calendar year taxpayer, it may deduct as interest expense under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) 8.00 currency A units in 1988, 7.86 currency A units in 1989, and 7.71 currency A units in 1990. The remainder of each payment is a return of principal. (5) X must allocate and apportion

its interest expense under section 1.861-8 of the regulations (subject to section 864(e) of the Code).

Example (3). Synthetic functional currency liability (nonfunctional currency borrowing hedged with forward contracts) - - lower interest rate currency. The facts are the same as example 2, except the interest rate on the currency B borrowing is 6 percent, payable annually, and the amount of currency A units received in exchange for the proceeds of the currency B borrowing pursuant to the terms of the forward contract is 100.04. X purchases currency B forward, in exchange for currency A, pursuant to the following schedule:

DATE	CURRENCY A	CURRENCY B
December 31, 1988	6.12	6
December 31, 1989	6.23	6
December 31, 1990	112.16	106

The currency B borrowing (which constitutes a qualifying transaction under section 2(b)) and the series of forward contracts (which constitute a hedge under section 2(c)) are a qualified hedging transaction under section 2(a). Accordingly, the currency B borrowing and the forward contracts are integrated and treated as one transaction with the following consequences: (1) The integration of the currency B borrowing and the forward contracts results in a deemed currency A borrowing in an amount equal to the currency A units received on December 31, 1987 for the 100 units of borrowed currency B. Accordingly, the issue price under section 1273(b)(2) is 100.04 currency A units. (2) The total amount of interest and principal paid by X with respect to the deemed currency A borrowing is equal to the currency A payments made by X under the forward purchase contracts (i.e., 6.12 currency A units in 1988, 6.23 currency A units in 1989, and 112.16 currency A units in 1990). (3) The deemed currency A borrowing is treated as an installment obligation within the meaning of § 1.1273-1(b)(2)(i) of the proposed regulations, and its stated redemption price at maturity (defined in section 1273(a)(2) of the Code and § 1.1273-1(b)(2)(ii) of the proposed regulations as the sum of all payments to be made under the borrowing other than qualified periodic interest) is 106.15 currency A units (i.e., under § 1.1273-1(b)(1)(ii), 6.12 units of the currency A payments in 1988, 1989 and 1990 are qualified periodic interest payments). Since the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the deemed currency A borrowing has OID equal to 6.11 currency A units. (4) The yield to maturity of the deemed currency A borrowing is 8.00 percent, compounded annually. Assuming X is a calendar year taxpayer, it may deduct as interest expense 8.00 currency A units in 1988, (of which 1.88 currency A units constitutes OID), 8.15 currency A units in 1989, (of which 2.03 currency A units constitutes OID), and 8.32 currency A units in 1990, (of which 2.20 currency A units constitutes OID). The amount of the final payment in excess of the total interest expense is a return of principal and a payment of previously accrued OID. (5) X must allocate and apportion its interest expense under section 1.861-8 of the regulations (subject to section 864(e) of the Code).

Example (4). Synthetic functional currency asset (nonfunctional currency denominated debt instrument hedged with forward contracts) - - higher interest rate currency. X, a U.S. corporation, has currency A as its functional currency. (The term "currency A" is used to designate a functional currency which, subject to the limitations of section 985, can be the United States dollar or any other currency.) On December 24, 1987, (the trade date) when the spot rate is one unit of currency A equals one unit of currency B, X enters into a forward contract to purchase 100 units of currency B forward from a bank in exchange for 99.96 units of currency A for delivery on December 31, 1987. The 100 units of currency B is to be used for the purchase of a currency B denominated debt instrument on December 31, 1987. The instrument will have a term of 3 years, an issue price of 100 currency B units, and will bear interest at 10 percent, payable annually, with no repayment of principal until the final installment. X also enters (on December 24, 1987) into a series of forward contracts to sell the currency B interest and principal payments for currency A according to the following schedule:

DATE	CURRENCY A	CURRENCY B
December 31, 1988	9.81	10
December 31, 1989	9.64	10
December 31, 1990	104.07	110

The rate of return on the currency B denominated debt instrument and the exchange rates on the forward contracts are fixed on December 24, 1987. On December 31, 1987, (the settlement date) X takes delivery of the 100 units of currency B and purchases the currency B denominated debt instrument. Assume X satisfies the identification and verification requirements of section 3 of this notice.

The purchase of the currency B denominated debt instrument (which constitutes a qualifying transaction under section 2(b) of this announcement) and the series of forward contracts (which constitute a hedge under section 2(c)) are a qualified hedging transaction under section 2(a). Accordingly, the currency B denominated debt instrument and the forward contracts are integrated and treated as one transaction with the following consequences: (1) The integration of the currency B denominated debt instrument and the forward contracts results in a deemed currency A denominated debt instrument in an amount equal to the currency A units exchanged under the forward contract to purchase the units of currency B necessary to acquire the currency B denominated debt instrument. Accordingly, the issue price is 99.96 currency A units (section 1273(b)(2) of the Code). (2) The total amount of interest and principal received by X with respect to the deemed currency A denominated debt instrument is equal to the currency A units received under the forward sales contracts (i.e., 9.81 currency A units in 1988, 9.64 currency A units in 1989, and 104.07 currency A units in 1990). (3) The deemed currency A denominated debt instrument is an installment obligation within the meaning of section 1.1273-1 (b)(2)(i) of the proposed regulations, and its stated redemption price at maturity (defined in section 1273(a)(2) of the Code and §1.1273-1(b) (2)(ii) of the proposed regulations as the sum

of all payments to be made under the debt instrument other than qualified periodic interest) is 99.96 currency A units, (i.e., under § 1.1273-1(b)(1)(ii) 8.00 units of the currency A payment in 1988, 7.86 units of the currency A payment in 1989, and 7.71 units of the currency A payment in 1990 are treated as qualified periodic interest payments). Since the stated redemption price at maturity is equal to the issue price, under section 1273(a)(1) there is no OID on the deemed currency A denominated debt instrument. (4) The yield to maturity (as defined in §1.1272–1(f) of the proposed regulations) of the deemed currency A denominated debt instrument is 8.00 percent, compounded annually. Assuming X is a calendar year taxpayer, it must include interest income of 8.00 currency A units in 1988, 7.86 currency A units in 1989 and 7.71 currency A units in 1990. The remainder of each payment received is a payment of principal. (5) The source of the interest income (stated in (4) above) shall be determined by applying sections 861(a)(1) and 862(a)(1) with reference to the currency B denominated interest income that would have been received had the transaction not been integrated.

Example (5). Synthetic functional currency asset (nonfunctional currency denominated debt instrument hedged with forward contracts) - -lower interest rate currency. The facts are the same as in example 4, except the interest rate on the currency B denominated debt instrument is 6 percent, compounded annually, and on December 24, 1987 (the trade date), X enters into a forward contract to purchase 100 units of currency B in exchange for 100.04 units of currency A for delivery on December 31, 1987. X sells forward the amount of currency B that will be received under the terms of the currency B denominated debt instrument according to the following schedule:

DATE	CURRENCY A	CURRENCY B
December 31, 1988	6.12	6
December 31, 1989	6.23	6
December 31, 1990	112.16	106

The currency B denominated debt instrument (which constitutes a qualifying transaction under section 2(b) of this announcement) and the series of forward contracts (which constitute a hedge under section 2(c)) are a qualified hedging transaction under section 2(a). Accordingly, the currency B denominated debt instrument and the forward contracts are treated as one transaction with the following consequences: (1) The integration of the currency B denominated debt instrument and the forward contracts result in a deemed currency A denominated debt instrument in an amount equal to the currency A exchanged under the forward contract to purchase the units of currency B necessary to acquire the currency B denominated debt instrument. Accordingly, the issue price of the deemed currency A denominated debt instrument is 100.04 currency A units (section 1273(b)(2) of the Code). (2) The total amount of interest and principal received by X with respect to the deemed currency A denominated debt instrument is equal to the currency A units received under the forward sales contracts (i.e., 6.12 currency A units in 1988, 6.23 currency A units in 1989, and 112.16 currency A units in 1990). (3) The deemed currency A denominated debt instrument is an installment obligation within the meaning of § 1.1273–1(b)(2)(i) of the proposed regulations, and its stated redemption price at maturity (defined in section 1273(a)(2) of the Code and § 1.1273-1(b)(2)(ii) of the proposed regulations as the sum of all payments to be made under the debt instrument other than qualified periodic interest) is 106.15 currency A units (i.e., under § 1.1273-1(b)(1)(ii) of the proposed regulations, 6.12 units of the currency A payments in 1988, 1989, and 1990 are qualified periodic interest payments). Since the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the deemed currency A denominated debt instrument has OID of 6.11 currency A units. (4) The yield to maturity of the deemed currency A debt instrument is 8.00 percent, compounded annually. Assuming X is a calendar year taxpayer, it must include interest income of 8.00 currency A units in 1988 (of which 1.88 currency A units constitutes OID), 8.15 currency A units in 1989 (of which 2.03 currency A units constitutes OID), and 8.32 currency A units in 1990 (of which 2.20 currency A units constitutes OID). The amount of the final payment received by X in excess of the interest income includible is a return of principal and a payment of previously accrued OID. (5) The source of the interest income (stated in (4) above) shall be determined by applying section 861(a)(1) and 862(a)(1) with reference to the currency B denominated interest income that would have been received had the transaction not been integrated.

SECTION 5. TREATMENT OF A QUALIFYING TRANSACTION AND A HEDGE THAT FAIL TO QUALIFY AS A QUALIFIED HEDGING TRANSACTION

Application of sections 263(g), 1092 and 1256. Sections 63(g), 1092 and 1256 of the Code and the regulations thereunder apply to a qualifying transaction and a hedge that fail to qualify under section 2 of this announcement as a qualified hedging transaction.

SECTION 6. APPLICATION OF SECTIONS 1441 AND 1442

The provisions of this notice do not affect the obligation of any person to withhold under sections 1441 and 1442 with respect to actual interest payments on a qualifying transaction.

SECTION 7. CONTACT PERSONS

For further information, contact Jeffrey Dorfman or Alice Armitage Neff at the Office of the Associate Chief Counsel (International), Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attn: CC:INTL:Br5); Telephone 202-566-3407 (not a toll free call). For information regarding the application of the original issue discount rules to transactions described in this announcement, contact Theresa Bearman at the same address and phone number.

SECTION 8. PAPERWORK REDUCTION ACT

The collection of information in this notice has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 and has been approved by O. M. B. (Control No. 1545-0983).

Chapter 61

MODIFICATIONS TO THE SOURCE OF INCOME AND DEDUCTIONS RULES

C. David Swenson, Esq.
Baker & McKenzie
Washington, D.C.

I. Introduction

The United States system of international taxation contains rules designed to identify items of income and expense derived from both United States and foreign sources. The rules relating to the source of income and deductions are among the most important set of rules found in the Internal Revenue Code. The source of income and expenses has a direct impact on the United States federal income taxation of United States citizens and residents, as well as on foreign persons deriving either passive income from the United States or active business income from a trade or business conducted within the United States. Thus, the rules impact virtually every taxpayer that earns income related in one way or another to the United States.

Over the years, the source of income and deduction rules have remained relatively unchanged. Recently, however, the Tax Reform Act of 1984 [1] provided a number of significant modifications to the source rules. In particular, the 1984 Tax Reform Act amended the source of transportation income rules and provided new rules relating to the resourcing of United States source income for purposes of the foreign tax credit limitation rules set forth in §904,[2] as well as to the recharacterization of certain income as interest for foreign tax credit purposes. Despite the extensive changes brought by the Tax Reform Act of 1984, Congress decided to enact in 1988 perhaps the most significant set of modifications to the source rules that has occurred since their inception.

II. Treasury Department Recommendations

A. *Introduction*

The primary origin of the 1986 changes to the source rules was proposals recommended to President Reagan by the Treasury Department in 1984. Despite the recent enactment of the Tax Reform Act of 1984 and its significant changes to the source of income rules, in November of that year, the Treasury Department made extensive proposals for amending the Code, including provisions modifying the source of income and deduction rules. The Treasury Department's proposals relating to the source rules were contained in a report to the President,[3] and set forth four basic changes regarding (i) sales income, (ii) income from sales of intangible property, (iii) so-called "80-20 corporation" rules dealing with interest and dividends, and (iv) the allocation and apportionment of interest expense rules.

The Treasury Department was of the view that the existing source rules should be changed to conform to the following basic principles:

• ***Economic Activity.*** Appropriate source of income rules should allocate income to the place where the economic activity generating the income occurs. Income derived from the use of property or capital should be sourced where the property or capital is used.[4]

• ***Neutrality.*** The source rules should be neutral in the sense that the United States should have no ground for objection if its source of income rules were applied by other countries. International norms for source of income determinations should be followed to the extent such norms exist.[5]

• ***Clear and Ready Application.*** The source rules should also be clear and readily applied. In that regard, the Treasury Department was of the view that adoption of a *per country* foreign tax credit limitation would increase the need for such clarity by requiring that the source of income be identified with specific foreign countries, rather than simply requiring allocation between domestic and foreign sources.[6] The Treasury Department was concerned that the existing source rules failed to satisfy these standards, at least as such rules applied to sales income, dividend and interest income from 80-20 companies, and the allocation of interest expenses.[7]

In particular, with respect to sales income, Treasury was concerned that under the existing title passage test, the source of income derived from the sale of goods bears no necessary relationship to the economic activity generating

[1] P.L. 98-369.

[2] All section references are to the Internal Revenue Code of 1954, as amended, or to the applicable Treasury Regulations promulgated thereunder (hereinafter the "Code").

[3] Treasury Department Report, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Chapter 18.02, at 364 (November 1984) (hereinafter referred to as the "1984 Treasury Report." References are to Chapter 18.02 unless otherwise indicated.).

[4] 1984 Treasury Report at 365.

[5] 1984 Treasury Report at 366.

[6] 1984 Treasury Report at 366. The Treasury Department's proposals included a recommendation for the adoption of a per country foreign tax credit limitation. 1984 Treasury Report, Chapter 18.01.

[7] 1984 Treasury Report at 366.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

that income. Because the place of title passage may be arbitrarily determined by affected taxpayers, Treasury was of the view that the existing rule permitted artificial manipulation of the foreign tax credit limitation and the United States tax base. The possibility of such manipulation was particularly troublesome to Treasury in connection with transactions between related taxpayers.[8]

In connection with sales of *intangible* property, the Treasury Department noted that income derived from the sale of such property is sourced under a title passage test while income derived from the license of such property is sourced by reference to the place where the property is used. Since the economic distinction between a sale and a license of intangible property is often elusive, Treasury was of the view that clarity and uniformity of treatment would be served by applying the same source of income rules to all transactions involving intangible property.[9]

The existing source rules applicable to dividend income focus on the domicile of the corporation distributing the income. Such rule, or a close variant thereof focusing on the corporation's place of management, is followed in the tax systems of most countries. Treasury thought that the rule is clear and easily applied and otherwise satisfies the characteristics of appropriate source rules. However, the exception to such general rule for so-called 80-20 companies was much more questionable to Treasury. In particular, the Treasury Department thought such exception alters a sound, well accepted, rule under circumstances where most foreign countries do not assert a competing source-based claim to tax the income. Consequently, this could, in Treasury's view, result in total tax exemption of the dividend both in the United States and the relevant foreign country, and could facilitate tax haven opportunities for taxpayers.[10]

Treasury also thought that, just as with dividends, the 80-20 exception to the general source rule applicable to interest income alters an accepted rule in the absence of competing source-based claims of foreign countries. Accordingly, Treasury stated that the 80-20 company rule, as applied to interest income, gives rise to tax haven type opportunities for some taxpayers and to opportunities for manipulation of the foreign tax credit limitation.[11]

Finally, in the case of interest expense, Treasury stated that the separate company method of allocation enables taxpayers to limit artificially the interest expense allocated to foreign source income by manipulating the corporate structure of the related group. As a result, there may be an unwarranted increase in the amount of foreign tax credit available to a related group of corporations.[12]

Based on these fundamental principles and the perceived inadequacies in the existing rules, the Treasury Department recommended to President Reagan four basic changes to the source rules.

[8] 1984 Treasury Report at 365.
[9] 1984 Treasury Report at 366.
[10] 1984 Treasury Report at 366.
[11] 1984 Treasury Report at 366.
[12] 1984 Treasury Report at 366.

B. Source Rules Relating to Sales Income

The Treasury Department proposed that, in general, income derived from the purchase and resale of inventory-type goods should be sourced in the country of the taxpayer's residence. An exception to this general rule would be provided if the predominant portion of the selling activity generating the income is carried on through a fixed place of business located outside the taxpayer's country of residence.[13] In such a case, the income would be sourced in the country where the fixed place of business is located. The place where title to the goods passes to the buyer, the place where purchasing activity is carried out, and the place of ultimate destination of the goods all would be irrelevant for purposes of determining the source of sales income. Treasury believed that this rule would correlate the source of sales income more closely with the location of the underlying selling activity, without necessitating in every case an administratively complex determination of where the relevant sales activity occurs.

Treasury also proposed that similar changes be made in the rules for determining the source of income derived from the manufacture and sale of products. The existing practice of sourcing one-half of such income on the basis of the place of manufacturing would continue. The remaining one-half of the income would be attributed to sales activity and would be sourced on the basis of the residency rules described above. Further, Treasury recommended that the title passage test be abandoned. Accordingly, no portion of the income derived from the manufacture of products in the United States and the sale of such products abroad would be sourced in a foreign country, *unless* the predominant selling activity giving rise to the sales income is carried out through a fixed place of business in that foreign country. The option of applying an independent factory price in allocating divided source income would be retained, provided that the predominant portion of the relevant sales activity is conducted through a fixed place of business outside the country of manufacture.[14]

C. Income Derived from Sales of Intangible Property

In connection with income from the sale of intangible property, the Treasury Department suggested that the rules relating to royalty income derived from licenses of intangible property be retained in their present form. Source rules relating to sales of intangible property would be modified to correspond generally to the rules relating to licenses. Accordingly, under Treasury's proposal, intangible property-related sales income generally would be sourced on the basis of where the underlying property is used.[15]

D. 80-20 Corporation Rules Relating to Interest and Dividends

Further, the Treasury Department proposed repeal of the 80-20 corporation exceptions to the general source rules applicable to dividend and interest income. Thus, dividend income would be sourced on the basis of the place of incorporation of the corporation paying the dividend. (An 80-20 corporation is a U.S. corporation which receives more

[13] 1984 Treasury Report at 366.
[14] 1984 Treasury Report at 367.
[15] 1984 Treasury Report at 367.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

than 80% of its income from foreign sources.) Interest income received from all United States residents and domestic corporations would be sourced on the basis of the residence of the payor, without examining the underlying source of the payor's income. Treasury recommended that the provisions of the existing source rules relating to interest income, designed to provide tax exemptions for particular activities, should not be repealed but should be restructured as overt exemption provisions in the interest of establishing neutral source rules.[16]

E. Allocation of Interest Expense

In addition, Treasury suggested that interest expense should be required to be allocated to income from various sources on a combined group basis, rather than on a separate company-by-company basis. Thus, manipulations of the corporate structure of a related group would not necessarily limit the amount of interest expense allocated to foreign sources.[17]

The Treasury Department's proposals were designed to create a set of rules for determining the source of income that is less subject to manipulation and more reflective of real underlying economic activity than the existing rules. Treasury said the new rules would also be more suitable to the computation of the foreign tax credit limitation on a per country basis. Treasury anticipated that under its proposals greater amounts of the income derived from sales of products to destinations located outside the United Sates would be treated as domestic source income. Consequently, certain amounts of foreign tax credits on income from United States economic activity might not be available under Treasury's proposed rules. In Treasury's view, the United States should retain the primary taxing right over this income.[18]

III. The President's Tax Proposals

A. Introduction

Based in part on the Treasury Department's recommendations, President Reagan delivered to Congress, in May 1985, a fundamental set of changes to the Code, including amendments to the source of income and deduction rules.[19] The President's proposals relating to the source rules differed from the Treasury Department recommendations in several important respects.[20]

The President's proposals were based on several basic principles that should be applied in formulating rules for determining the source of income. In particular, the Administration was of the view that appropriate source of income rules should reflect the location of the economic activity generating the income and the source of legal protections facilitating the earnings of that income. Income derived from the use of property or capital ordinarily should be sourced where the property or capital is used, under this view. Second, agreeing with the Treasury, the President proposed that the rules be neutral in the sense that the United States should have no ground for objection if its source of income rules were applied by other countries. Unless there are sufficient reasons to the contrary, international norms for source of income determinations should be followed to the extent such norms exist, according to the President's Report.[21]

Third, the President's Report stated that the rules should not allow erosion of the legitimate United States tax base through taxpayer manipulation of the source rules or of the foreign tax credit limitation. In the Administration's view, the rules should generally preserve the residence country's taxing right in cases where other countries typically do not assert a source basis claim to tax the income. Fourth, to the extent possible the rules should operate clearly and not require difficult factual determinations on a transaction-by-transaction basis. Clarity and ease of application would be even more important under the President's proposals to calculate the foreign tax credit limitation on a *per country* basis because of the requirement that income be sourced to specific foreign countries.[22]

With respect to the existing rules, the President's Report noted that such rules are deficient in the following respects:

• ***Sales Income.*** Under the existing title passage test, according to the President's Report, the source of income derived from the sale of goods bears no necessary relationship to the economic activity generating that income. Particularly where property manufactured in the United States is sold to a sales subsidiary abroad, half or more of the income from the sale may be treated as foreign source income even though only a negligible portion of the seller's relevant economic activity may occur outside the United States.

Because the place of title passage may be arbitrarily determined by affected taxpayers, the President's Report stated that the existing rule permits artificial manipulation of the foreign tax credit limitation and the United States tax base.[23] Most foreign countries do not tax sales income merely because title passes in that country. Thus, according to the Administration, the existing United States source rule surrenders United States primary taxing jurisdiction over sales in many situations where the income is not taxed abroad. Under the foreign tax credit limitation provisions, a zero foreign tax on such income may be averaged with foreign source income that is highly taxed by a foreign country. The President's Report stated that such averaging artificially increases the amount of the foreign taxes imposed by a high tax country that may be credited against United States tax liability and thereby permits the credit for the foreign tax to reduce United States tax otherwise due on income derived from what is essentially domestic economic activity.[24]

---

[16] 1984 Treasury Report at 368.
[17] 1984 Treasury Report at 368.
[18] 1984 Treasury Report at 369.
[19] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985) (hereinafter the "1985 President's Report." References are to Chapter 15.02 unless otherwise indicated.).
[20] 1985 President's Report at 397.
[21] 1985 President's Report at 399.
[22] 1985 President's Report at 399. As in the case of the 1984 Treasury Report, the President's Report recommended that the foreign tax credit be calculated on a per country basis. 1985 President's Report, Chapter 15.01.
[23] 1985 President's Report at 399.
[24] 1985 President's Report at 400.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

• ***Sales of Intangible Property.*** Income derived from the sale of intangible property is generally determined under a title passage test while income derived from the license of such property is determined by reference to the place where the property is used. Existing rules that treat sales and licenses similarly are limited in their scope. The Administration was of the view that the title passage rule is no more satisfactory when applied to sales of intangible property than when it is applied to sales of tangible property. Moreover, the principal factor giving intangible property value is the legal protection afforded that property in the country where it is used, a factor arguing for a source rule based on the place of use in all transactions involving intangible property.[25]

• ***Dividend Income.*** The existing source rule applicable to dividend income focuses on the place of incorporation of the corporation distributing the dividend income. The Administration stated that the exception to this general rule for so-called 80-20 companies alters a sound, well accepted rule under circumstances where most foreign countries do not assert a competing source-based claim to tax the income. Because foreign countries normally do not tax such dividends, the treatment of the 80-20 company dividend as foreign source may have the effect of making what would otherwise be excess foreign tax credits usable. This occurs despite the fact that a full foreign tax credit is available with respect to the foreign tax on the 80-20 corporation's operating income. The Administration was of the view that frequently the result will be the total exemption of the 80-20 dividend from shareholder level tax either in the United States or in the country where the earnings were derived. Moreover, the Administration said that foreign taxpayers may be able to use an 80-20 holding company to convert distributions by United States operating subsidiaries into foreign source income and thereby avoid United States withholding tax on those distributions.[26]

• ***Interest Income.*** As in the case of dividends, the Administration stated that the 80-20 exception to the general source rule applicable to interest income alters an accepted rule in the absence of competing source-based claims of foreign countries. The 80-20 rule for interest therefore gives rise to the same type of United States withholding tax avoidance and total United States and foreign tax exemption as does the 80-20 dividend rule. Where it is desirable to provide a United States tax exemption for specific classes of interest income, the Administration was of the view that such exemption should be done directly rather than through modifications to the source rules.[27]

• ***Transportation Income.*** Under current rules, large portions of transportation services income are treated as earned in international waters or skies and outside the generally asserted source taxing jurisdiction of any country. The Administration was concerned that such income may therefore go totally untaxed as a result of the foreign tax credit mechanism. Section 861(e) modifies the general source rule for income and related expenses derived from United States-produced vessels and aircraft leased to United States persons. The general source rule is abandoned solely to provide an indirect subsidy for users of United States-produced ships and aircraft by allocating losses on the lease of such ships and aircraft to the United States, so as to avoid a reduction in the foreign tax credit limitation. The Administration was of the view that this subsidy is inappropriate in a system of neutral source rules, and an appropriate source rule would reflect the economic activity generating the income.[28]

• ***Allocation and Apportionment of Interest Expense.*** Under current Treasury Regulations, treatment of a single taxpayer's interest expense under the fungibility approach generally apportions interest expense to income based on the relative value of assets used to generate the income. The Treasury Regulations also permit allocation on the basis of gross income provided the result does not depart significantly from the result of an asset-based allocation. The Administration stated that it is inappropriate, however, to apply the fungibility concept on a separate company basis when a taxpayer is a member of an affiliated group and is included in a consolidated return. The Administration was also concerned that the separate company method of allocation enables taxpayers to limit artificially the interest expense allocated to foreign source income by simply manipulating the location of borrowing within the consolidated group. According to the Administration, this may result in an unwarranted increase in the amount of foreign tax credit available to a consolidated group of corporations.[29]

Further, the President's Report stated that the inclusion of tax-exempt interest and assets generating tax-exempt interest in the allocation formula has similarly provided opportunities for artificial inflation of the foreign tax credit limitation. The inclusion of exempt United States source income and assets in the expense allocation increases the amount of expense allocated to United States source income even though the income generated is not subject to United States tax. The President's proposed change complements the Administration proposal to deny deductions to all taxpayers for interest incurred to carry tax-exempt obligations. However, the change in expense allocation rules would have been justified, in the Administration's view, in the absence of a change in the rules relating to deductibility of the expense.[30]

Based on the above-described principles and deficiencies in the existing source rules, President Reagan recommended to Congress changes in five primary areas, each of which is discussed below.

B. Source Rules Relating to Sales Income

The Administration proposed that income derived from the sale of personal property be divided into three broad categories for purposes of determining source: (i) income from sales of inventory-type property in the ordinary course of business; (ii) income from sales of non-inventory property used in a trade or business; and (iii) income from sales of other personal property including personal financial proper-

[25] 1985 President's Report at 400.
[26] 1985 President's Report at 400.
[27] 1985 President's Report at 401.
[28] 1985 President's Report at 401.
[29] 1985 President's Report at 401.
[30] 1985 President's Report at 401.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ty, such as stocks, bonds and commodities contracts.[31] Under the President's recommendation, income derived from the purchase and resale of inventory-type goods would have been sourced in the country of the taxpayer's residence. An exception to the general rule would apply if the seller maintained a fixed place of business located outside of its country of residence and that fixed place of business participated materially in generating the income. In such a case, the income would be sourced in the country where the fixed place of business is located. However, all sales to a taxpayer's foreign subsidiaries and affiliate would be sourced at the seller's residence even if the seller maintains a fixed place of business in another country. For these purposes, a fixed place of business maintained by an independent distributor would not be attributed to the seller for purposes of the source rule. The place where title to the goods passes to the buyer, the place where purchasing activity is carried out, and the place of ultimate destination of the goods all would be irrelevant for purposes of determining the source of sales income.

The Administration's proposal modified the original Treasury Department recommendation by requiring only that a foreign fixed place of business participate materially in a sale, rather than conduct the predominant portion of the selling activity, in order to qualify for the exception to the residence-based source rule. Such change would have made the source rule correspond to the principles of existing §864(c)(4)(B)(iii) and could assist in avoiding disputes over the relative contribution of sales activity conducted in two places of business. The Administration was of the view that its proposal would correlate the source of sales income with the location of the underlying selling activity more closely than does existing law.[32]

Under the Administration's proposal, similar changes would have been made in the rules for determining the source of income derived from the manufacture and sale of inventory-type products. The existing practice of sourcing an arbitrary percentage of such income on the basis of the place of manufacture would have continued, but the remaining portion of the income would be attributed to sales activity and would be sourced on the basis of the rules described above. Thus, the title passage test would have been eliminated for inventory-type products.

As a result, under the Administration's proposal, no portion of the income derived from the manufacture of products in the United States and the sale of such products abroad would have been sourced in a foreign country unless the seller maintained a fixed place of business in that foreign country and that place of business participated materially in the sale. Similarly, the sale of property manufactured by the taxpayer in the United States to a foreign sales subsidiary or affiliate would have generated no foreign source income.

Current law arbitrarily divides income between manufacturing and sales activities on a fifty/fifty basis. The Administration was concerned that such division overallocates income to selling activity in many cases. Therefore, the Administration stated that it would consider whether a fixed percentage allocation apportioning greater income to manufacturing activity would more appropriately be applied as a general rule to divide the income. Under the Administration's proposals the special manufacture-sale rules in the existing regulations relating to United States possessions would have been eliminated and the rules described above would be applied to such sales.[33]

C. Income Derived from Sales of Intangible Property

Under the Administration's proposals, the rules relating to royalty income derived from licenses of intangible property would have been retained in their present form. Source rules relating to sales of intangible property, however, would be modified to correspond to the rules relating to licenses. Accordingly, under the President's recommendations, income derived from the sale of intangible property, other than passive investment property, would be sourced on the basis of where the underlying property was to be used.[34]

D. 80-20 Corporation Rules Relating to Interest and Dividends

Under the Administration's proposals, the 80-20 corporation exceptions to the general source rules applicable to dividend and interest income would be repealed. Thus, dividends received from a domestic corporation earning most of its income outside the United States would be sourced on the basis of the place of incorporation of the corporation paying the dividend. Interest income received from all United States residents and domestic corporations would be sourced on the basis of the residence of the payor without looking to the underlying source of the payor's income. As in the case of dividends, the provisions of the existing source rules relating to interest income that are designed to provide tax exemptions for particular activities would not have been repealed, but would be restructured as overt exemption provisions in the interest of establishing neutral source rules. As a result, under the Administration's proposals, interest paid on deposits in United States banks would be treated as United States source income, but would be exempt from tax if the interest was paid to a nonresident alien individual or foreign corporation and was not effectively connected with the conduct of a trade or business in the United States.[35]

E. Transportation Income

The Administration also proposed that consideration be given to modifications to the rules relating to transportation income in order to cause those rules to reflect more accurately the underlying economic activity, to more fully exercise United States taxing jurisdiction over income not taxed abroad, and to make those rules operate in a manner consistent with a per country foreign tax credit limitation. Specifically, the Administration recommended that more general application of the 50% convention applied to possessions-related transportation income be considered.[36]

[31] 1985 President's Report at 402.
[32] 1985 President's Report at 402.
[33] 1985 President's Report at 403.
[34] 1985 President's Report at 403.
[35] 1985 President's Report at 403.
[36] 1985 President's Report at 484.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

F. Allocation of Interest Expense

Under the Administration's proposals, interest expense incurred by a corporation joining in filing a United States consolidated return would be required to be allocated to income from various sources on a consolidated group basis. The assets or gross income of all members of the consolidated group would be aggregated for purposes of determining the percentage of interest expense to be allocated to foreign income. That percentage would then be applied to the interest expense of each member of the group in calculating the foreign tax credit under the consolidated return regulations. The Administration recommended that the separate company basis of allocation be retained for taxpayers not filing a consolidated return.

Only deductible expenses are required to be allocated between foreign and domestic sources in calculating net taxable income from foreign sources. In order to reach the "proper" result when a portion of a taxpayer's interest expense is not deductible because it is incurred to carry tax-exempt obligations, the President's Report recommended that tax-exempt interest income, and assets generating tax-exempt interest income, be considered in allocating interest expense to foreign source income for purposes of the foreign tax credit calculation.[37]

G. Basis for Proposals

The Administration was of the view that these proposals would create a set of rules for determining the source of income that more clearly reflects the situs of relevant economic activity than do the existing rules. The proposals regarding the source of sales income and the source of interest and dividends paid by 80-20 companies would also limit the circumstances in which the United States cedes its primary tax jurisdiction by treating income that is not ordinarily taxed by foreign countries as a foreign source income for United States tax purposes.

According to the Administration, these rules would appropriately restrict the ability of United States taxpayers to "average down" high foreign tax rate income and to use foreign tax credits to offset United States tax on income derived from domestic economic activity. The source rule proposals also complemented the Administration's proposed modifications to the foreign tax credit limitation and provided rules more suitable to separate country sourcing of income.[38]

IV. Tax Reform Act of 1985: Proposals by the House to Modify the Source Rules

A. Introduction

Based on the proposals set out in the Treasury Department Report to President Reagan and on the Administration's recommendations to Congress, the House of Representatives passed, in late 1985, the Tax Reform Act of 1985 (H.R. 3838). The Tax Reform Act of 1985 (hereinafter the "House Bill") provided significant changes to the foreign income tax area of the Code, including the source of income and deduction rules.

[37] 1985 President's Report at 484.
[38] 1985 President's Report at 485.

Specifically, the amendments contained in the House Bill to the source rules related to the following six areas: (i) determination of the source of income derived from sales of personal property; (ii) limitations on the 80-20 company rules; (iii) source rules for transportation income; (iv) source rules for space and certain ocean activities; (v) allocation and apportionment of expenses to foreign source income; and (vi) modifications to the rules on allocation of research and experimental expenditures.

B. Determination of Source of Income Derived from Sales of Personal Property

The House Bill provided significant changes to the rules relating to income arising from sales of personal property, inventory property, depreciable personal property, and intangible property.

1. Income from the Sale of Personal Property: In General

The House Bill provided that income derived from the sale of personal property, tangible or intangible, by a United States resident is generally sourced in the United States. Similar income derived by a nonresident was treated in the House Bill as foreign source. For purposes of the House Bill, the term "sale" included an exchange or other disposition. Also, any possession of the United States was treated as a "foreign country." [39]

The House Bill generally provided that an individual is a resident of the United States if the individual has a tax home (as defined in §911(d)(3)) in the United States. The House Bill provided that any corporation, partnership, trust, or estate which is a United States person (as defined in §7701(a)(30)) generally is a United States resident. All other individuals and entities were generally nonresidents for purposes of the source rules.

However, the House Bill contained an exception to the above-described residence rules for United States citizens and resident aliens (within the meaning of §7701(b)) in determining their residency for source purposes. The exception provided that a United States citizen, or a resident alien, will not be treated as a resident of another country with respect to any sale of personal property unless the gain from the sale is actually taxed by such country.[40] Thus, under the House Bill, a United States citizen or resident alien could not maintain a tax home in another country, sell his personal property, claim residency in such country, and generate foreign source income unless he or she actually paid tax on the income from such sale to that country.

The House Bill provided further exceptions to the general rule for determining residency when income is effectively connected with the conduct of a trade or business. If an item of income was "effectively connected" with the conduct of a trade or business in the United States by a nonresident, the nonresident was treated as a United States resident for purposes of determining the source of such income.[41]

[39] H.R. Rep. No. 426, 99th Cong., 1st Sess. 362 (1985) (hereinafter "House Report").
[40] House Report at 362.
[41] House Report at 363.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Similarly, the House Bill provided that if an item of income was "effectively connected" with the conduct of a trade or business in a foreign country under United States effectively connected principles, a United States resident would be treated as a nonresident of the United States for purposes of determining the source of such income.[42] However, the residence rule did not apply to any inventory property that was produced in whole or in part in the United States. As stated at page 363 of the House Report:

> Assume, for example, a corporation is incorporated under the laws of the United States and is engaged in the exploration and development of oil and natural gas. Part of its operations include the exploration and development of an oil and gas deposit in a foreign country. Under United States effectively connected principles, the corporation is engaged in a trade or business in the foreign country and the income from the sale of oil and gas derived from that country is effectively connected with such trade or business. Under the bill, the corporation is a nonresident of the United States for purposes of determining the source of its income derived from the sale of oil and gas from its deposits in that foreign country. It is not a nonresident of the United States, however, for purposes of determining the source of oil and gas income derived from the sale of oil and gas deposits in the United States.

The House Ways and Means Committee was apparently aware that some of the source rules in the House Bill would conflict with source rules prescribed in United States income tax treaties. The source rules in the House Bill reflected the committee's policy that income not taxed, or not likely to be taxed, by a foreign country should not be treated as foreign income for purposes of the foreign tax credit limitations. The House Ways and Means Committee did not intend that the treaty source rules should apply in a manner which would frustrate the policy underlying the source rules contained in the House Bill that untaxed income not increase a United States taxpayer's foreign tax credit limitation.[43]

2. Income from the Sale of Inventory Property

Under the House Bill, income derived from the sale of inventory property (as defined in §1221(1), relating to stock in trade or other property primarily held for sale to customers in the ordinary course of its business), produced in whole or in part by the taxpayer, would have been allocated between production activity and sales activity for sourcing purposes. The income allocated to production activity would have been sourced where the activity occurs (as under present law). The income allocated to sales activity, however, would have been generally sourced under the residence-of-the-seller rule described above.[44]

Income from the sale by a United States resident of inventory property produced by such United States resident that would be allocated to sales activity, and income from the purchase and sale of inventory property by a United States resident, would have been sourced outside the United States only if (i) the property sold was for use, consumption, or disposition outside the United States, (ii) an office or other fixed place of business, outside the United States, of the United States resident materially participated in the sale, and (iii) the sale was not made to an affiliate of the United States resident.[45] Thus, under the provisions of the House Bill, a United States resident would generate foreign source income on the sale of inventory property when a foreign office of the United States resident conducted a material part of the sales activity, the sale was to an unrelated person, and the property was not sold for use, consumption, or disposition in the United States. The House Bill also provided, however, that a United States resident's office or fixed place of business in a foreign country would be disregarded for purposes of determining the source of the United States resident's inventory sales income in the event a treaty prevented such country from imposing income tax on the income. In such a case, the income would have been United States source income.[46]

3. Income from the Sale of Depreciable Personal Property

The House Bill provided that gain, to the extent of prior depreciation deductions, from the sale of depreciable personal property would be sourced in the United States if the depreciable deductions giving rise to such income were previously allocated against United States source income. If the deductions giving rise to such income were previously allocated against foreign source income, gain from such sales (to the extent of prior deductions) would be sourced without the United States. Any gain in excess of prior depreciation deductions would be sourced pursuant to the rule relating to the country of the residence of the seller.[47]

Depreciation deductions, as defined in the House Bill, were any depreciation or amortization or any other deduction allowable under any provision of the Code which treats an otherwise capital expenditure as a deductible expense. Depreciable personal property, as defined in the House Bill, was any personal property if the adjusted basis of the property included depreciation adjustments. Depreciation adjustments were defined as adjustments reflected in the adjusted basis of any property on account of depreciable deductions (whether allowed with respect to such property or other property and whether allowed to the taxpayer or to any other person).

The House Bill also provided a rule of convenience for purposes of determining the source of income from the sale of certain depreciable personal property. This rule provided that if the property was either used predominantly in the United States or predominantly outside the United States for any taxable year, the taxpayer was required to treat the allowable deductions for such year as being allocable entirely against United States source or foreign source income, as appropriate. Such rule was provided so as not to require a segregation of previously allowable deductions if

[42] *Id.* However, the residence rule did not apply to any inventory property that was produced in whole or in part in the United States.

[43] *Id.*

[44] *Id.*

[45] *Id.* In this regard, an affiliate would have been any person bearing a relationship to the United States resident that is described in §482 of the Code.

[46] House Report at 364.

[47] *Id.*

the person knew the property was used predominantly in the United States.[48]

4. Income from the Sale of Intangible Property

With respect to intangible property, the House Bill provided that income derived from the sale of such property, to the extent the payments were not contingent on the productivity, use, or disposition of the intangible, was sourced under the general rule relating to personal property sales. That is, income derived from such sales would be sourced in the country of the seller's residence. If payments were contingent on productivity, use, or disposition, the source rules applicable to royalties would apply. For purposes of the House Bill, the term "intangible property" was defined to mean any patent, copyright, secret process or formula, goodwill, trademark, trade name or other like property. Notwithstanding the general rule, income attributable to goodwill would have been sourced where the goodwill was generated.[49]

The House Bill also repealed §871(e) of the Code (relating to the treatment of certain payments from the sale of intangible property to the extent that such payments are contingent on the productivity, use, or disposition of such property). The House Bill provided that, for purposes of determining whether a withholding tax is due, taxpayers were required to segregate the gain from the sale or exchange of applicable intangible property into gain contingent on the productivity, use, or disposition of such property and gain which is not so contingent.[50]

C. Limitations, Dividends and Interest Paid by 80-20 Companies

Under the House Bill, interest paid by an 80-20 company would have been generally United States source income. The House Bill also provided, at p. 367, that dividends from an 80-20 company (other than a corporation that had an election in effect under §936) were to be treated as United States source income.

The House Bill provided an exception from the United States source rule for certain interest received by a "financial institution" (as described in §§581 or 591) or by a similar foreign financial institution. Under such exception, interest income was foreign source if: (i) the interest paid by the payor corporation was attributable to the active conduct of a trade or business in a foreign country by the payor corporation, a subsidiary or chain of subsidiaries of the payor corporation (or a partnership of which the payor corporation was a partner), and the payor corporation was an 80-20 company, (ii) the payor corporation was not related to the financial institution, and (iii) the interest received by the financial institution was "effectively connected" with the conduct of a trade or business of the financial institution in a foreign country.[51] Thus, for example, under the House Bill, an 80-20 company engaged in an active trade or business in a foreign country would pay foreign source interest to a branch of an unrelated United States bank or other United States or foreign financial institution as long as such interest was effectively connected with the financial institution's trade or business in the foreign country.[52]

The House Bill further provided that certain interest paid by an 80-20 company, though treated as United States source, would be exempt from withholding. Such exemption applied to interest paid (to a nonresident alien individual or other foreign person) by an 80-20 corporation if that interest was attributable to the active conduct of a trade or business in a foreign country by the 80-20 corporation, a subsidiary or chain of subsidiaries of that corporation, or a partnership of which the 80-20 company was a partner. Thus, under the House Bill an 80-20 company conducting an active trade or business in a foreign country generally could borrow from a foreign person and not withhold United States tax on the interest payments as long as the interest was "effectively connected" with the 80-20 company's business.[53]

The House Ways and Means Committee intended that the exemption from withholding apply to interest of an 80-20 corporation that was in a "start-up" phase of an active trade or business in a foreign country. The corporation could pay interest and not withhold United States tax as long as the interest was related to the corporation's start-up activities, the 80-20 company was not foreign owned, and the interest was not paid to related persons.[54]

The House Bill further provided that certain other interest, although treated as United States source, was not subject to the withholding tax provided in §§871 and 881. Such interest, whether received by a nonresident alien individual or other foreign person, included interest on deposits with persons carrying on the banking business, interest on deposits or withdrawable accounts with a Federal or State chartered savings institution (as long as such interest was a deductible expense to the savings institution under §591), and interest on amounts held by an insurance company under an agreement to pay interest thereon. This rule applied, however, only if such interest was not "effectively connected" with the conduct of a trade or business within the United States by the recipient of the interest.[55] Under present law, these types of interest income are treated as foreign source income and thus are generally not subject to United States tax if paid to foreign persons. The House Bill, however, treated such income as United States source income, but excluded this income from withholding.

---

[48] House Report at 364-365. A segregation of allowable deductions was required, however, for certain personal property generally used outside the United States (personal property described in §48(a)(2)(B)). That is, the rule of convenience did not apply to such property. House Report at 365.

[49] House Report at 365.

[50] House Report at 365. Withholding would have been required only with respect to United States source payments that were contingent on the productivity, use or disposition of such property.

[51] House Report at 367.

[52] House Report at 367-368.

[53] House Report at 368. This exemption from withholding by an 80-20 company did not apply, however, if the 80-20 company was 50% owned (by voting power for all classes of stock entitled to vote or by value) by nonresident alien individuals or other foreign persons, and the interest was paid to a recipient who was a related party to the payor. Thus, interest payments by a foreign-owned 80-20 company made to a related party would be subject to United States withholding tax.

[54] *Id.* A business was in a "start-up" phase if substantially all of its other expenditures were start-up expenditures (as described in §195).

[55] *Id.* The House Bill also exempted from withholding tax the income derived by a foreign central bank of issue from bankers' acceptances.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

D. Source Rule for Transportation Income

The House Bill provided that 50% of all "transportation income" attributable to transportation which begins or ends in the United States would be United States source income. The House Bill did not change the present law definition of transportation income. Also, as under present law, the House Ways and Means Committee did not intend to subject services performed in a foreign country that have an indirect connection with the transportation that begins or ends in the United States to the provisions of the House Bill.

The House Bill also repealed the special rule in §861(e), relating to the lease or disposition of vessels, aircraft, or spacecraft which are constructed in the United States, and the special rule relating to the lease of an aircraft to a regularly scheduled United States air carrier.[56] The source of such transportation income would be determined under the general rule described above.

The House Bill only applied to transportation income attributable to transportation that begins or ends in the United States. Thus, for example, under the House Bill, if a voyage that begins in the Far East has intermediate stops before it arrives in the United States, 50% of the income that is attributable to the cargo (or persons) carried from its port of origin to the United States would be United States source income.[57]

The House Ways and Means Committee intended round-trip travel of persons (or cargo) by a carrier to be treated as transportation income attributable to transportation that begins (for the outbound portion) or ends (for the inbound portion) in the United States under the provisions of the House Bill. Thus, 50% of the income attributable to the outbound transportation and 50% of the income attributable to the inbound transportation would be United States source.[58]

The House Bill's provision for income from transportation into the United States was intended to apply regardless of whether a foreign country treated the income from such transportation as within its taxing jurisdiction. For example, if a voyage from a foreign country to the United States was treated by the foreign country as income from domestic sources, 50% of the income from the voyage would still be United States source income.

The House Bill also provided definitive rules for when a foreign person was considered to have income which is "effectively connected" with the conduct of a United States trade or business.[59] Section 613(b) provided that the foreign person was considered to have transportation income "effectively connected" with the conduct of a United States trade or business if the person had a fixed place of business in the United States which assists in earning the transportation income, and substantially all of the person's United States source gross transportation income was attributable to regularly scheduled transportation.[60]

E. Source of Income Rule for Space and Ocean Activities

Under the House Bill, all income from space or ocean activities would have been sourced in the country of residence of the person generating the income: income derived by a United States resident would be United States source income and income derived by a nonresident would be sourced outside the United States. For these purposes, the terms "United States resident" and "nonresident" had the same meaning as assigned to such terms in the House Bill.[61]

Space or ocean activities as defined by the House Bill included any activities for the use (or hiring or leasing for use) of a spacecraft and any activities conducted on or beneath water not within the jurisdiction (as recognized by the United States) of any country including the United States or its possessions. The term "ocean activities" also included any activities performed in Antarctica.[62]

Under the provisions of the House Bill, space or ocean activities did not include any activity which gives rise to transportation income, or any activity with respect to mines, oil and gas wells, or other natural deposits to the extent the mines or wells were located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions.

The House Bill also provided an anti-conduit provision in the case of certain foreign corporations. In particular, a foreign corporation would be treated as a United States resident if 50% or more in value of the corporation is owned, or considered as owned, by United States persons.[63] Thus, United States persons could not incorporate a foreign corporation in order to be taxed as a nonresident of the United States.[64]

F. Allocation and Apportionment of Expenses to Foreign Source Income

In the context of the source rules relating to deductions, the House Bill provided, in general, that for purposes of the foreign tax credit limitation of §904, the taxable income of each member of an affiliated group from sources outside the United States would be determined by allocating and apportioning all interest expenses as if all members of the group were a single corporation. In effect, taxpayers would be required to disregard stock of affiliates and interaffiliate debt in allocating interest expenses.[65] The House Ways and Means Committee intended that regulations would provide appropriate treatment to effectively eliminate interest payments among members of an affiliated group that join (or

[56] §863(c)(2)(B); House Report at 370-371.

[57] House Report at 371.

[58] *Id.* For example, 50% of the income attributable to the first and last legs of round-trip travel by a cruise ship, originating in the United States, calling on foreign ports, and ending in the United States was intended to be United States source. Similarly, 50% of the income attributable to both legs of an air carrier traveling from the United States to a foreign country, and back to the United States (or from a foreign country to the United States, and back to a foreign country), was intended to be United States source. *Id.*

[59] §613(b) of the House Bill.

[60] House Report at 371.

[61] §611 of the House Bill.

[62] House Report at 382.

[63] "Owned" is defined at page 382 of the House Report as within the meaning of §958(a) and (b).

[64] House Report at 382. The provision applied regardless of the number of persons interposed between the corporation earning the income and its ultimate owners. *Id.*

[65] House Report at 377.

could join) in the filing of a consolidated return. Therefore, the only interest expense taken into account would be interest paid to non-members of the group. The House Bill did not change the treatment of non-recourse debt that the current regulations treat as definitely related to specific property.[66]

As indicated at page 377 of the House Report, the House Bill also applied a similar rule in the case of expenses other than interest, but granted regulatory authority to the Secretary of the Treasury to provide exceptions, if any, as appropriate. For this purpose, too, taxpayers were, in effect, to disregard stock of affiliates and interaffiliate debt. The House Ways and Means Committee anticipated that regulations would modify the separate company system of current law to provide look-through rules where appropriate to properly reflect all foreign source income earned by all members of the group.[67]

In addition, the House Bill specified that taxpayers were to allocate and apportion interest expense on the basis of assets rather than gross income. That is, the House Bill prevented taxpayers from using the optional gross income method under the current regulations (or any similar method) for allocating and apportioning interest.

With respect to tax-exempt assets, the House Bill provided that such assets and income associated therewith would not to be taken into account in allocating or apportioning any deductible expense. For this purpose, 85% of the basis (or value, if the taxpayer used the fair market value method) of stock that paid dividends that were eligible for the 85% dividends received deduction would be treated as a tax-exempt asset.[68]

Further, the House Bill provided a new rule for purposes of allocating and apportioning expenses on the basis of assets when the asset was stock in one of certain foreign corporations. In general, the adjusted basis of any asset which was stock in a controlled foreign corporation in the hands of a 10% United States shareholder was to be increased by the amount of the earnings and profits of the foreign corporation attributable to that stock and accumulated during the period the taxpayer held such stock.[69] In the case of a deficit in earnings and profits of the foreign corporation that was attributable to the stock that arose during the period when the 10% United States shareholder held the stock, such deficit was to reduce the adjusted basis of the asset in the hands of the United States shareholder. In that case, however, the deficit could not reduce the adjusted basis of the asset below zero.

The House Bill's one-taxpayer rule also provided new treatment under the asset method for stock in affiliated United States companies. The House Ways and Means Committee intended that stock of affiliates and intercompany debt between affiliates be disregarded under appropriate rules prescribed by the Treasury Department. Therefore, as members of an affiliated United States group earned income that was retained, such income would be reflected in assets whose tax basis would be considered in the allocation of expenses under the asset method.[70] The treatment was comparable, therefore, to the treatment given the stock of foreign corporations.

Example: A United States parent company borrowed $360 with an obligation to pay annual interest of $36. The debt was recourse debt. The United States parent borrower owned two assets. One of its assets was stock of a domestic subsidiary, which stock had a basis in the parent's hands of $800. The United States subsidiary in turn owns the following assets: United States assets which had a basis in its hands of $700, and foreign assets which had a basis in its hands of $100. The other asset of the United States parent (the borrower) was stock in a foreign corporation. The basis of the stock in the foreign corporation in the hands of the United States owner was $100. The foreign corporation also had retained earnings of $100.

Under the House Bill, after a transition period, the interest expense allocation rules would operate on the basis of the affiliated group consisting of the United States parent corporation and its United States subsidiary. The parent would be treated in effect as owning directly the $700 of United States assets owned by the United States subsidiary, and the $100 of foreign assets owned by the United States subsidiary. In addition, the parent would be treated as owning $200 of foreign assets by virtue of its $100 basis in the stock of the foreign subsidiary increased by the $100 of earnings and profits of the foreign subsidiary. Thus, the parent would be treated as owning $700 of United States assets and $300 of foreign assets for the purpose of the asset method. Therefore, 70% of the parent's interest expense ($700/$1,000) would reduce United States source gross income. The parent corporation would allocate $10.80 (30% of $36) against foreign source income and $25.20 (70% of $36) against United States source income. The same result would obtain if the United States subsidiary had borrowed the money and paid the interest.[71]

The House Bill also contained an exception to the rule requiring treatment of an affiliated group as if all members of the group were one taxpayer for purposes of allocating and apportioning interest expense. The general rule would not apply to any financial institution if the business of the financial institution was predominantly with persons other than related persons or their customers, and if the financial institution was required by State or Federal law to be operated separately from any other entity which is not a financial institution. If such exception applied, the financial institution would not be treated as a member of the group for purposes of applying the House Bill's general "one taxpayer" rule to other members of the group. The other members of the group would still be treated as one taxpayer for interest expense allocation purposes.[72]

[66] *See* Regs. §1.861-8(e)(2)(iv).

[67] House Report at 377.

[68] *Id.* As the 85% deduction changed in amount, the percentage of stock treated as a tax exempt asset would also change.

[69] House Report at 378. For this purpose, the adjusted basis of stock in a controlled foreign corporation would also to reflect capital contributions.

[70] House Report at 378.

[71] *Id.*

[72] House Report at 379. The financial institution would still be part of the group that the House Bill treated as one taxpayer for expenses other than interest.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

G. *Modification to Rules on Allocation of Research and Experimental Expenditures*

Under the House Bill, for taxable years beginning generally after August 1, 1985, and on or before August 1, 1987, the application of the Treasury Regulations research expense allocation rules[73] were effectively liberalized in three respects. Such liberalizations applied notwithstanding other changes made by the House Bill in the Code's expense allocation rules.[74] As detailed at page 387 of the House Report, the House Bill retained the regulatory rule[75] under which research expenditures are allocated entirely to one geographic source if such expenditures were incurred to meet legal requirements imposed with respect to improvement or marketing of specific products or processes and cannot reasonably be expected to generate income (beyond *de minimis* amounts) outside that geographic source.

For the specified two-year period, the House Bill provided that 50% of all remaining amounts allowable as a deduction for qualified research and experimental expenditures would be apportioned to United States source income and deducted from such income in determining the amount of taxable United States source income. Thus, the House Bill had the effect of increasing the automatic place-of-performance apportionment percentage for United States-based research expense from 30% to 50%. Under the House Bill, a taxpayer will be able to apportion to United States source income 50% of the United States-based research expense remaining after any allocation of such expense incurred to meet legal requirements.[76]

Further, the House Bill provided that, for the specified two-year period, the portion of those amounts allowable as a deduction for qualified research and experimental expenditures that remain after any legal requirements allocation and the 50% automatic place-of-performance apportionment would be apportioned on the basis of sales or gross income. Thus, the House Bill made automatic place-of-performance apportionment available temporarily to taxpayers who would elect to apportion expenses using the optional gross income method, as well as to taxpayers choosing the standard sales method of apportionment. The House Bill also had the effect of temporarily suspending the regulatory rule that prohibits taxpayers from using the optional gross income method to reduce allocation of research expense to foreign source income by more than 50% over what the allocation to foreign source income would be under the standard sales method.[77]

The House Bill's temporary modifications to the research expense allocation rules applied for purposes of computing taxable income from United States sources and from sources partly within and partly without the United States. The modifications applied only to the allocation of research and experimental expenditures for the purposes of geographic sourcing of income. Such rules did not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation.[78]

V. The Senate Amendment to H.R. 3838: Modifications to the Source Rules

The proposals set forth in the House Bill relating to modifications in the source of income and deductions rules provided the basis for the changes suggested in the Senate Amendment to H.R. 3838.[79] In the area of the source rules, the Senate addressed each of the items covered by the House Bill, but in a number of cases, the Senate proposed substantial modifications.

A. *Source of Income from Sales of Personal Property*

1. *In General*

The Senate Amendment to H.R. 3838 provided that income derived from the sale of personal property, tangible or intangible, other than inventory property and depreciable personal property, by a United States resident generally would be sourced in the United States. Similar income derived by a nonresident generally would be treated as foreign source. For purposes of the Senate Amendment, the term sale included an exchange or other disposition. Income that United States persons derived from the sale of inventory property (as defined in Code §1221(1)) continued to be sourced under present law (*i.e.*, under the title passage rule).[80]

The Senate Amendment generally provided that an individual was a resident of the United States if the individual had a tax home[81] in the United States. The Senate Amendment also provided that any corporation, partnership, trust, or estate which is a United States person generally was a United States resident. All other individuals and entities generally were considered nonresidents for purposes of the source rules under the Senate Amendment.

2. *Special Rules for United States Persons*

Unlike the House Bill, the Senate Amendment contained an exception to the above-described residence rules for United States citizens and resident aliens. As stated at page 311 of the Senate Report, the exception provided that United States citizens and resident aliens would not be treated as nonresidents with respect to any sale of personal property unless the gain from the sale was actually taxed at a rate equal to or exceeding 10% in a foreign country. Thus, a United States citizen or resident alien could not maintain a tax home in another country, sell his personal property, claim residency in such country, and generate foreign source income unless the person actually pays tax on the income from such sale to a foreign country at a 10% rate or higher.[82]

---

[73] Regs. §1.861-8.
[74] §614 of the House Bill.
[75] Regs. §1.861-8(e)(3)(i)(B).
[76] House Report at 388.
[77] *Id.*
[78] *Id.* The rules also did not apply for purposes of the computation of combined taxable income of a Foreign Sales Corporation or Domestic International Sales Corporation.
[79] Senate Amendment to H.R. 3838 (June 24, 1986) (hereinafter the "Senate Amendment").
[80] S. Rept. No. 313 99th Cong. 2d Sess. 330 (1986) (hereinafter "Senate Report").
[81] The term "tax home" was defined in §911(d)(3).
[82] Senate Report at 331.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The Senate Amendment also provided two special rules for gains derived by United States residents. The first special rule provided that United States residents deriving income from sales of personal property (other than inventory property) attributable to an office or other fixed place of business maintained outside the United States generate foreign source income. Such rule did not apply, however, if the income from the sale was not actually taxed at a 10% rate or higher in a foreign country. This special rule was designed to reflect the Senate Finance Committee's general intention that the source of income from substantive operations should be the location of those operations.[83]

The second special rule provided that if a United States resident sold stock of an affiliate in the foreign country in which the affiliate derived from the active conduct of a trade or business more than 50% of the gross income for the 3-year period ending with the close of the affiliate's taxable year immediately preceding the year during which the sale occurred, any gain from the sale would be foreign source. The term "affiliate," for this purpose, was defined to mean any corporation (including a foreign corporation) whose stock (both voting power and value) is at least 80% owned.[84]

3. Income Derived from the Sale of Depreciable Personal Property

Subject to a special rule, the Senate Amendment provided that gain, to the extent of prior depreciation deductions, from the sale of depreciable personal property would be sourced in the United States if the depreciation deductions giving rise to such income had been allocated previously against United States source income. If the deductions giving rise to such income had been allocated previously against foreign source income, gain from such sales (to the extent of prior deductions) would be sourced outside the United States. Any gain in excess of prior depreciation deductions would be sourced pursuant to present law, *i.e.*, sourced pursuant to the title passage rule.[85]

As in the case of the House Bill, the Senate Amendment provided a special rule for purposes of determining the source of income from the sale of certain depreciable personal property. Such rule provided that if personal property was either used predominantly in the United States or predominantly outside the United States for any taxable year, the taxpayer must treat the allowable deductions for such year as being allocable entirely against United States source or foreign source income, as appropriate. This rule was provided so as not to require a segregation of previously allowable deductions if the person knew the property was used predominantly in the United States or predominantly outside the United States.[86]

4. Income Derived from the Sale of Intangible Property

Similar to the House Bill, the Senate Amendment provided that in the case of income derived from the sale of intangible property, to the extent the payments were not contingent on the productivity, use, or disposition of the intangible, the general rule for sourcing income from personal property sales would apply. Specifically, income derived from such sales would be sourced in the country of the seller's residence. If payments were contingent on productivity, use, or disposition, the source rules applicable to royalties would apply.[87]

5. Income Derived from the Sale of Personal Property by Foreign Persons

In the case of nonresidents, the Senate Amendment repealed the title passage rule with respect to sales of all personal property (except for foreign tax credit purposes). The term nonresident was defined pursuant to the bill's general definition. The Senate Amendment provided that income derived from sales of personal property that were attributable to an office or other fixed place of business maintained in the United States by a nonresident was generally treated as United States source income (except for foreign tax credit purposes). Pursuant to the Code's general rules defining "effectively connected" income, such income was considered effectively connected and would be subject to United States tax. The Senate Amendment provided, however, that if a source country imposed a tax on such income, the income would be treated as foreign source for purposes of §906 (so as to allow the nonresident a foreign tax credit).[88]

Income derived by nonresidents that would be treated as United States source by the rules described above would not be treated as United States source, however, if the property was sold or exchanged for use, consumption, or disposition outside the United States, and an office or other fixed place of business maintained outside the United States by such person materially participates in the sale.

The Senate Amendment clarified that gain from the sale of stock in a controlled foreign corporation by a United States shareholder that is treated under §1248(a) as a dividend would be sourced pursuant to the source provisions governing dividends (*i.e.*, generally, such income would be sourced in the residence of the payor). Further, the Senate Amendment provided that regulations were to be prescribed by the Treasury Department for carrying out the purposes of its provisions including the application of the rules to income derived from trading in futures contracts, forward contracts, options contracts, and similar securities.[89]

B. 80-20 Dividend and Interest Rules

The Senate Amendment provided that interest and dividends paid by an 80-20 company are subject to a

[83] *Id.* The Senate Amendment provided that current law principles were to apply in determining when sales were attributable to an office or other fixed place of business.

[84] *Id.*

[85] Senate Report at 331-332.

[86] Senate Report at 332. A segregation of allowable deductions was required, however, for certain personal property generally used outside the United States (personal property described in §48(a)(2)(B)).

[87] *Id.*

[88] Senate Report at 332-333. Current law principles were to apply in determining when sales are attributable to an office or other fixed place of business.

[89] Senate Report at 333.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

lookthrough rule that bases the source of those dividends and interest on the source of the income earned by the 80-20 company. Such look-through rules were to apply to both foreign and United States recipients.

In the case of interest paid by an 80-20 company, the amount treated as United States source would be the ratio of gross income derived from United States sources, for the three-year period (or for the period of the corporation's existence, if shorter) ending with the close of the taxable year of such corporation preceding the year of payment of such interest to total gross income of the company. For interest treated as United States source, the Code's general tax and withholding rules would apply. That is, United States source interest paid to foreign persons would be subject to taxation under §871 and 881, and the withholding provisions of §§1441 and 1442.[90]

In the case of dividends paid by an 80-20 company, the amount of the dividend treated as United States source would be determined by the ratio of the 80-20 company's gross income derived from United States sources for the three-year period (or for the period of the corporation's existence, if shorter) ending with the close of the taxable year of such corporation preceding the year of declaration of the dividends, to total gross income of the company. The Senate Amendment's look-through rule did not apply to dividends paid by a corporation that had an election in effect under Code §936.[91]

The Senate Amendment similarly applied a look-through rule for interest paid by a resident alien individual who derives more than 80% of his gross income from foreign sources. For interest payments made by such individuals, the amount treated as United States source would be the ratio of gross income derived from United States sources by such individuals for the three-year period ending with the close of the taxable year of such individuals preceding the payment of the interest, to total gross income of the individuals.[92]

The source rules in the Senate Amendment applied before the application of the resourcing rules enacted in the Tax Reform Act of 1984. If a greater amount was treated as United States source under those provisions, however, such amount would be treated as United States source (but only for foreign tax credit limitation purposes).[93]

C. Income from Transportation Activities

1. Source of Transportation Income

As explained at page 341 of the Senate Report, the Senate Amendment provided that 50% of all transportation income attributable to transportation which begins or ends in the United States would be United States source. This provision applied equally to U.S. and foreign persons. The Senate Amendment modified present law by excluding from transportation income the performance of services by alien seamen or airline employees with respect to transportation that begins or ends in the United States. Income from the performance of services would still be transportation income for transportation that begins and ends in the United States and for transportation between the United States and a United States possession. The Senate Finance Committee intended, however, that transportation income not include income derived from the lease of a vessel if such vessel was not used to transport cargo or persons for hire.[94]

The Senate Amendment applied only to transportation income attributable to transportation that begins or ends in the United States. Cargo or passengers on a voyage beginning outside the United States, which were off-loaded at intermediate ports before arrival in the United States, would not give rise to United States source income.[95]

2. Gross-Basis Tax

The Senate Amendment generally provided for a four percent gross-basis income tax on the United States source transportation income of foreign persons. The tax was to be applied to gross United States source transportation income defined under present law, with modifications. The Senate Amendment provided that the four percent tax applied if the Code's 30% tax (under §§871 and 881) would otherwise apply (for example, to bareboat charter income).

The Senate Amendment provided, however, consistent with present law, that if a foreign person is engaged in a trade or business in the United States and the foreign person's transportation income is effectively connected with that trade or business, the foreign person must, in lieu of paying the four percent gross-basis tax, file a United States tax return and pay tax on the basis of its net income. If a foreign person's transportation income were effectively connected with the conduct of a United States trade or business, such income, like other effectively connected income, would also be subject to the Senate Amendment's branch profits tax.[96] Similarly, however, if a foreign person's income were exempt from either the gross tax or net-basis tax because of a reciprocal exemption or treaty exemption, such income would also be exempt from the branch profits tax.

The Senate Amendment also provided that individuals or corporations resident of a country that the Treasury Department determines imposes a gross-basis tax on transportation income of United States persons would not be eligible to be taxed on a net basis. Thus, the gross tax was to apply to residents of such countries even if their income would ordinarily be effectively connected with a United States trade or business. The Senate Amendment provided that a foreign corporation would be considered to be resident of a "listed" country if the corporation was organized in such a country, or if 50% or more of the value of the stock of such corporation was beneficially owned under §958(a) and (b) by individuals who are residents of such countries.[97]

---

[90] Senate Report at 335.

[91] *Id.* Present law would therefore be retained for dividends paid by such corporations: dividends paid by such corporations would continue to be treated as foreign source.

[92] Senate Report at 335-336.

[93] Senate Report at 336.

[94] Senate Report at 341. In such instances, the Committee intended such income to be characterized as ocean activity income and be sourced in the country of residence of the person earning the income.

[95] Senate Report at 341.

[96] *See* §951 of the Senate Amendment.

[97] Senate Report at 342. The Senate Finance Committee intended that, in determining ultimate residence for purposes of allowing net basis taxation, United States shareholders of controlled foreign corporations

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Under the Senate Amendment, foreign persons who were not resident of a listed country could elect to treat United States source transportation income not effectively connected with the conduct of a United States trade or business under general Code rules (*i.e.*, income from bareboat charters) as income which is effectively connected with the conduct of a United States trade or business.[98] Failure to make such election meant that the four percent gross tax applied to such income, unless otherwise exempt (as, for example, under the reciprocal exemption).

The Senate Amendment's gross-basis tax was to be collected by return. However, the Senate Finance Committee stated that it would continue to study whether alternate, potentially more effective, methods of collecting the tax were feasible. Finally, the gross-basis tax in the Senate Amendment was not intended to override United States income tax treaties with foreign countries. Therefore, a foreign person that was able to avail itself of a treaty exemption would not be subject to such tax.[99]

3. Reciprocal Exemption

The Senate Amendment also modified the present law reciprocal exemption by requiring foreign persons to be resident of a foreign country that reciprocally exempts United States persons, rather than determining exemption based on the place of registry or documentation. The Senate Amendment provided that an alien individual must be a resident of a foreign country which grants United States citizens and domestic corporations an equivalent exemption in order for the alien individual to avail himself of the reciprocal exemption. The Senate Finance Committee intended that a country which, as a result of a treaty with the United States, exempts United States citizens and domestic corporations from tax in that country on income derived from the operation of ships or aircraft, should be considered to have an equivalent exemption, even though the treaty technically contains certain additional requirements other than residence, such as United States registration or documentation of the ship or aircraft.[100]

Under the Senate Amendment, a foreign corporation must be organized in a foreign country which grants United States citizens and domestic corporations an equivalent exemption in order for the corporation to avail itself of the reciprocal exemption. However, the Senate Amendment further provided that, in the case of a foreign corporation claiming a reciprocal exemption, if 50% or more of the ultimate individual owners of the foreign corporation determined under §958(a) and (b) are not residents of a foreign country that grants United States persons equivalent exemption (either by treaty or by reciprocal exemption), the foreign corporation would not able to claim the reciprocal exemption.[101]

Further, the Senate Amendment provided that the residence-based reciprocal exemption applies to gross income. Therefore, the residence-based reciprocal exemption provisions apply to the gross-basis tax. The Senate Amendment also expanded the reciprocal exemption to include income derived from the lease of vessels or aircraft as long as a foreign country exempts United States persons from its tax on comparable income. The Senate Amendment also provided regulatory authority to extend the reciprocal exemption by agreement on a partial basis.[102]

D. Source of Income from Space and Certain Ocean Activities

The Senate Amendment provided that all income derived from space or ocean activities should be sourced in the country of residence of the person generating the income. The Senate Amendment provided, however, an anti-conduit provision in the case of certain foreign corporations. A foreign corporation would be treated as a United States person if 50% or more in value, or in voting power, of the corporation is owned, or considered as owned, by United States persons.[103]

As explained at page 358 of the Senate Report, space or ocean activities included any activities conducted in space and on or beneath water not within the jurisdiction (as recognized by the United States) of any country including the United States or its possessions. For example, the Senate Finance Committee intended that the term "space or ocean activities" include the performance and provision of services in space or on or beneath the ocean, the leasing of equipment including spacecraft located in space or equipment located on or beneath the ocean, the licensing of technology or other intangibles for use in space or on or beneath the ocean, and the manufacturing of property in space or on or beneath the ocean. The Senate Finance Committee also intended the term ocean activities to further include activities performed in Antarctica and the leasing of a vessel if such vessel did not transport cargo or persons for hire between ports-of-call.[104]

The Senate Amendment also provided for regulations to describe other activities that could be considered space or ocean activities. For example, the Senate Finance Committee intended that underwriting income from the insurance of risks on activities conducted in space or on or beneath

would not be considered residents of a listed country. Moreover, a corporation the stock of which is primarily and regularly traded on an established securities exchange in the country in which the corporation is organized would be considered to be a resident of that country. In addition, if a parent corporation is organized in the same country as its subsidiary and its shares are primarily and regularly traded in the country in which its wholly-owned subsidiary is organized, both corporations would be considered resident of such country.

[98] Senate Report at 343. Such election was intended to allow operators or lessors of vessels or aircraft to account for their expenses in determining their United States tax liability.

[99] *Id.*

[100] *Id.*

[101] *Id.* For purposes of applying the 50% test to a foreign corporation (or other type of entity), if the foreign corporation was a United States controlled foreign corporation, the United States shareholders of the foreign corporation would be treated as residents of the foreign country in which the corporation was organized.

[102] Senate Report at 344. For example, if the United States and a foreign country agreed that only regularly scheduled transportation would be exempted from tax, then the Code's exemption could apply.

[103] Senate Report at 358.

[104] Senate Report at 358-359. For example, the income earned by a lessor of a vessel chartered by a corporation that is to engage only in research activities in the ocean would be high-seas income. In these circumstances, the Senate Finance Committee did not intend the lessors to earn transportation income since the operators of the vessels would not be engaged in transporting cargo or persons between ports-of-call.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the ocean be treated as space or ocean activities. However, the Committee did not intend the selling of property on the high seas to be considered space or ocean activity. Thus, the bill did not override the title passage rule.

The Senate Amendment also excluded from the definition of space or ocean activities "international communications income." The Senate Amendment provided that such income would be sourced 50% in the United States and 50% foreign to the extent the income was attributable to communications between the United States and a foreign country. If the communication was between two points within the United States, the income attributable thereto would be entirely United States source.

This result would follow even if the communication were routed through a satellite in space, regardless of the satellite's location. If the communication was between the United States and an airborne plane or a vessel at sea, the Senate Finance Committee also intended the communication to be treated as between two United States points, and, thus, to be sourced in the United States. Further, if the communication was between two foreign locations, the Committee intended income attributable thereto to be foreign source.[105] The Senate Finance Committee intended that international communication income include income attributable to any transmission between two countries of signals, images, sounds, or data transmitted in whole or in part by buried or underwater cable or by satellite.

E. Allocation and Apportionment of Expenses to Foreign Source Income

1. Interest Expenses

As a general rule, money is a fungible asset, and interest expenses can be prorated on the asset method. However, the Senate Amendment treated interest expense of a United States member of a corporate group as supporting only assets of the borrower, absent a guarantee or similar arrangement. More specifically, a United States company that borrows without a guarantee would be treated as using its interest expense to support only its assets, including, on a look-through basis, assets of corporations whose stock it owns. Absent a guarantee, its debt is not treated as supporting assets of upper-tier corporations (or brothersister corporations). However, in the case of an unguaranteed debt, an "equalizing" rule operates to return the allocation of related parties' expenses to an approach consistent with fungibility.[106]

The Senate Report indicates at p. 350-351 that, for purposes of interest expense allocation, the Senate Amendment included within the affiliated group whose interest expenses and assets enter the allocation determination not only members of the United States consolidated group (or corporations eligible to consolidate), but also foreign corporations that would be eligible to consolidate were such entities not foreign, and §936 companies (possessions corporations) that would be eligible to consolidate absent statutory prohibition. The Senate Amendment did not allow United States corporations to deduct interest expense incurred by foreign corporations. Nonetheless, the Senate Amendment considered foreign-born interest expenses in allocating the interest deduction of the United States members of the group. Thus, interest expense allocated to foreign source income under the one worldwide taxpayer rule of the Senate Amendment would be reduced by any interest expense incurred by a foreign member of the worldwide affiliated group if that foreign-born interest would have been allocated or apportioned to foreign source income of that foreign corporation under the principles of the Senate Amendment if applied separately to such foreign members of the group.

> *Example:* A United States parent company operated directly a United States business and owned a foreign operating subsidiary. The United States business and the foreign subsidiary each had $100 of assets. The foreign subsidiary earned $25 of net (pre-interest and pre-tax) foreign source income, but incurred $5 of interest expense. It distributed $20 to the parent as a dividend, and the parent had $20 of United States source income (pre-interest and pre-tax) from its United States business. The parent had no foreign income other than the dividend from its foreign subsidiary. The parent incurred $15 of interest expense that was not directly attributable to any particular income.
>
> Under present law, the $15 of interest expense would be evenly divided between the parent's United States income and foreign income ($7.50 each). The parent, therefore, had $12.50 of taxable United States income, and $12.50 of taxable foreign income. If both corporations were a single corporation, their combined $20 of interest expense would be allocated $10 against United States income and $10 against foreign income. Under the Senate Amendment, therefore, the interest expense allocated against foreign income would be $5. ($20 of worldwide interest expense multiplied by 100/200, the ratio of foreign assets to worldwide assets, and reduced by the $5 of interest directly incurred by the foreign subsidiary.) The remaining $10 of the parent's interest expense would be allocated to United States sources. The parent had $10 of net taxable United States income, and $15 of taxable foreign income. The $5 of interest expense that the foreign subsidiary incurs does not reduce United States tax, but enters into the allocation calculation.[107]

The Senate Amendment also specified that taxpayers were to allocate and apportion interest expense on the basis of assets rather than gross income. That is, the Code would no longer allow taxpayers to use the optional gross income method of the current regulation (or any similar method) for allocating and apportioning interest.

The Senate Amendment provided a special rule for certain unguaranteed debt of United States members of a group below the top corporate tier. In general, a United States corporation that was a member of an affiliated

[105] Senate Report, at 359. The Senate Finance Committee intended that international communication income include income attributable to any transmission between two countries of signals, images, sounds, or data transmitted in whole or in part by buried or underwater cable or by satellite. For example, the term includes income derived from the transmission of telephone calls.

[106] Senate Report at 350.

[107] Senate Report at 351.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

group and that incurred interest expense with respect to qualified debt (generally defined below to mean debt not guaranteed by a related party) could elect to allocate and apportion interest incurred with respect to that qualified indebtedness under the general rules of the Senate Amendment as though the corporation incurring the expense were the ultimate United States parent corporation of an affiliated group consisting of that United States corporation and its direct and lower-tier subsidiaries. For this purpose, qualified indebtedness included borrowing from unrelated parties that was not guaranteed or in any other way facilitated by any corporation within the same worldwide affiliated group as the borrower.[108]

The Senate Amendment also granted regulatory authority to treat other amounts that are economically the equivalent of interest as interest. Similarly, the Senate Finance Committee intended that amounts denominated as interest, but that are not interest as an economic matter, should not be treated as interest. In particular, the Committee recognized that deductions of life insurance companies described in §807(c)(1), (2), (3), and (6) should not be treated as interest expenses for such purpose.[109]

2. Expenses Other Than Interest

In the case of expenses other than interest (or research) that are not directly allocable to specific income producing activities, the Senate Amendment effectively treated the United States affiliated group as one taxpayer, but granted regulatory authority to the Treasury Department to provide exceptions, if any, as appropriate. That is, taxpayers were, in effect, to disregard stock of affiliates and interaffiliate debt. The Senate Finance Committee believed that this intended result would be achieved under regulations that retain the separate company method of allocation of current law, but that, unlike current law, treat stock in domestic subsidiary corporations as a foreign asset to the extent the domestic corporation (or its subsidiaries on a look-through basis) earns foreign source income.[110]

The Senate Finance Committee noted that when a corporation owns stock in subsidiaries, it may incur some expenses that are allocable to specific income producing activities. For instance, a corporation that owns stock in subsidiaries may also conduct direct operations on its own behalf. Expenses incurred to conduct those operations were allocable under the Senate Amendment to the income from those operations. If a corporation incurs expenses that werenot directly allocable to specific income producing activities, the Senate Amendment generally required the allocation of those expenses under the "one-taxpayer" principles that apply to interest expenses.[111]

The Senate Amendment also provided that tax-exempt assets and income associated therewith should not be taken into account in allocating or apportioning any deductible expense. This rule applied to all expenses including interest.[112] For this purpose, 80% of stock that paid dividends that are eligible for the 80% dividends received deduction would be treated as a tax-exempt asset.

The Senate Bill provided a new rule for purposes of allocating and apportioning expenses on the basis of assets when the asset is stock in one of certain corporations. In particular, if a corporation is not included in the worldwide affiliated group (generally a corporation that is more than 10 but less than 80% owned), then, in general, for this purpose, the adjusted basis of an asset which is stock in such corporation in the hands of a United States shareholder (or in the hands of a foreign subsidiary that is part of the group), would be increased by the amount of the earnings and profits of the corporation attributable to that stock and accumulated during the period the taxpayer held the stock.

Further, the Senate Amendment required the Treasury Department to prescribe such regulations as may be necessary to carry out the provisions discussed above. In particular, the Senate Finance Committee intended that, in the case of an affiliated group of corporations that is eligible to file a consolidated return but that does not do so, the foreign source income of any member of the group should not exceed the amount of foreign source income that would be attributable to that member if the group were a single corporation.[113] In addition, the Committee intended that regulations provide appropriate safeguards to prevent the transfer of assets from one consolidated group member to another to achieve a fair market value basis without recognition of gain (until the assets leave the group).

The Senate Finance Committee also intended that regulations provide for the apportionment of interest allocated to foreign source income among the various categories of foreign source income described in §904(d)(1), such as passive income and active (overall limitation) income. In particular, the Committee indicated that the regulations should provide that interest expense should be allocated against the type of income (such as "active" overall limitation income or separate limitation passive income) that a particular corporation earns.[114]

VI. Tax Reform Act of 1986: Modifications to the Source of Income and Deductions Rules

A. Introduction

The changes set forth in the Tax Reform Act of 1986 [115] relating to the source of income and deductions rules are

[108] Senate Report at 351-352. If one U.S. member of an affiliated group makes the election, the "look-down" treatment applied to all qualified interest of all U.S. members of the group.

[109] Senate Report at 353.

[110] *Id.*

[111] *Id.* The Senate Amendment does not treat such expenses as "fungible."

[112] Senate Report at 355.

[113] Senate Report at 355.

[114] Senate Report at 355-356.

[115] P.L. 99-514 (hereinafter the "1986 Act"). Title XVIII of the Tax Reform Act of 1986 also contained technical corrections to a number of pieces of prior tax legislation, including certain foreign provisions in the Tax Reform Act of 1984 (P.L. 98-369). The technical amendments to the 1984 Act's foreign provisions included modifications to the source rules related to (i) the resourcing of United States source income under §904, (ii) the recharacterization of dividend income as interest income under such section, and (iii) related party factoring under §864. Such technical corrections to the source rules in the 1984 Act are not discussed in this chapter.

based on the original 1984 Treasury Department proposals, President Reagan's 1985 recommendations to Congress, and compromises between the House and Senate versions of the legislation. The final bill contains significant amendments to the source rules which directly impact foreign tax credit calculations and the taxation of United States source income of foreign persons.

B. Determination of Source of Income Relating to Sales of Personal Property

1. Introduction

Section 1211 of the 1986 Act significantly alters the rules relating to the source of income derived from sales of personal property. Under current law, income derived from the purchase and resale of tangible and intangible personal property is sourced where title to the property passes to the purchaser. To the extent that personal property is depreciable or subject to other basis adjustments, gain attributable to the recapture of such adjustments is also sourced where title passes to the purchaser.

Further, under current law, income derived from the manufacture and sale of personal property is treated as having a divided source. Under Treasury Regulations, one-half of such income is generally sourced in the country of manufacture, and one-half of the income is sourced where title passes to the purchaser. The division of the income between manufacturing and selling activities must be made on the basis of an independent factory price, rather than on a 50/50 basis, if such a price exists.

2. General Rules

Section 1211 of the 1986 Act adds new §865 to the Code, providing new source rules for sales of personal property. As a general rule, §865 provides that the income from the sale of personal property shall be sourced as follows:

(i) if a United States resident sells the personal property, the income shall be sourced in the United States;[116] or

(ii) if a nonresident sells the personal property, the income shall be sourced outside of the United States.[117]

Thus, as a general matter, the source of income from the sale of property now depends directly on the residence of the seller.

For these purposes, the term "United States resident" means:

(i) any individual who has a tax home (as defined in §911(d)(3)) in the United States, and

(ii) any corporation, partnership, trust, or estate which is a United States person (as defined in §7701(a)(30)).[118]

In turn, the term "nonresident" means any person other than a United States resident.[119]

A special rule applies in the case of United States citizens and resident aliens in certain circumstances. In particular, such individuals will not be treated as nonresidents with respect to any sale of personal property unless an income tax equal to at least 10% of the gain derived from such sale is actually paid to a foreign country with respect to such gain.[120]

3. Sales of Inventory

Section 865(b) provides an exception to the above general rule in the case of income derived from the sale of inventory property. In the case of such income, §865 does not apply, and the income is sourced under the current rules set forth in §§861(a), 862(a), and 863(b).[121] Thus, income arising from sales of inventory is generally sourced under the current title passage rules, regardless of the actual source of residence of the seller.

For these purposes, the term "inventory property" means personal property described in §1221(1), relating to property held primarily for sale to customers in the ordinary course of business.[122] Further, for purposes of §865, the term "sale" includes an exchange or any other disposition.[123]

4. Depreciable Personal Property Exception

a. In General

New §865(c) provides a separate set of rules for depreciable personal property. In particular, §865(c) provides, generally, that gain (not in excess of depreciation adjustments) from the sale of "depreciable personal property" shall be allocated between sources in the United States and sources outside the United States in the following manner:

(i) by treating the same proportion of such gain as sourced in the United States as the United States depreciation adjustments with respect to such property bear to the total depreciation adjustments,[124] and

(ii) by treating the remaining portion of such gain as sourced outside the United States.[125]

Thus, gain from the sale of depreciable personal property will be sourced under this special sourcing rule and will be sourced in direct relation to the United States depreciation adjustments.

For these purposes, the term "depreciable personal property," means any personal property if the adjusted basis of such property includes depreciation adjustments.[126] Further, the term "depreciation adjustments" means adjustments reflected in the adjusted basis of any property on account of depreciation deductions, regardless of whether allowed with respect to such property or other property and whether allowed to the taxpayer or to any other person.[127]

[116] §865(a)(1).
[117] §865(a)(2).
[118] §865(g)(1)(A).
[119] §865(g)(1)(B).
[120] §865(g)(2).
[121] §865(b)(2).
[122] §865(h)(1).
[123] §865(h)(2).
[124] §865(c)(1)(A).
[125] §865(c)(1)(B).
[126] §865(c)(4)(A).
[127] §865(c)(4)(B).

In turn, the term "depreciation deductions" means any deductions for depreciation or amortization or any other deduction allowable under any provision which treats an otherwise capital expenditure as a deductible expense.[128]

b. Special Rule for Gain in Excess of Depreciation

If the sale of depreciable personal property generates gain in excess of the depreciation adjustments, such gain shall be sourced as if the property were "inventory property." [129] In such case, the gain will be sourced under the rules of §§861(a)(6), 862(a)(6), and 863(b), as appropriate under the circumstances.[130]

c. United States Depreciation Adjustments

For purposes of the depreciable personal property exception, the term "United States depreciation adjustments" means the portion of the depreciation adjustments to the adjusted basis of the property which are attributable to the depreciation deductions allowable in computing taxable income from sources in the United States.[131] There is, however, a special rule for property used predominantly inside or outside the United States. In particular, except in the case of property of a kind described in §48(a)(2)(B),[132] if for any taxable year:

(i) such property is used predominantly in the United States, or

(ii) such property is used predominantly outside the United States,

then all of the depreciation deductions allowable for such year shall be treated as having been allocated to income from sources in the United States, or, as the case may be, outside the United States.[133]

5. Special Rules for Intangible Property

Section 865(d) provides a special set of rules relating to the sale of intangible property. More specifically, in the case of any sale of an "intangible," the rules of §865 apply only to the extent that the payments in consideration of such sale are *not* contingent on the productivity, use, or disposition of the intangible.[134] In the event that such payments are so contingent, the source of such payments is determined as if such payments were royalties.[135] Thus, the payments will be sourced generally based on the location of use of the intangible.[136]

A separate rule applies with respect to the sale of goodwill. Payments in consideration of a sale of goodwill shall be treated as from sources in the country in which such goodwill was generated.[137]

6. Sales of Personal Property Through Offices or Fixed Places of Business

a. Sales by United States Residents

If a United States resident maintains an office or other fixed place of business *outside* of the United States, income from the sale of personal property attributable to such office or other fixed place of business shall be sourced *outside* the United States.[138] Such rule does *not* apply if the income is sourced under one of the following special rules set forth in §865:

(i) inventory property (§865(b));

(ii) depreciable personal property (§865(c));

(iii) intangibles (§865(d)); or

(iv) stock of affiliates (§865(f)).

Thus, the special rule relating to an office or other fixed place of business applies only to sales of personal property outside the ambit of these categories.

However, such rule does not apply unless an income tax equal to at least 10% of the income from the sale is actually paid to a foreign country with respect to such income.[139] Congress did not want to encourage the establishment of offices in "pure" tax havens in order to change the source of the income from the sale of personal property.

b. Sales of Personal Property by Nonresidents

If a nonresident of the United States maintains an office or other fixed place of business in the United States, income attributable to such location from *any* sale of personal property, *including inventory property,* shall be sourced in the United States.[140] Thus, regardless of the nonresident's place of residence or the type of property sold (*e.g.*, intangibles, stock of affiliates, inventory), income attributable to the nonresident's office or fixed place of business in the United States shall be sourced in the United States.

Such source rule does *not* apply, however, for purposes of §971, relating to export trade corporations.[141] Further, such rule does *not* apply to any sale of inventory property which is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the taxpayer *outside* the United States materially participated in the sale.[142] In addition, the rule does not apply to any amount included in gross income of a United States shareholder under §951(a)(1)(A).[143]

For purposes of determining (i) whether a taxpayer has an office or other fixed place of business, and (ii) whether a sale is attributable to such location, the principles of §864(c)(5) apply.[144]

[128] §865(c)(4)(C).
[129] §865(c)(2).
[130] §865(b).
[131] §865(c)(3)(A).
[132] §48(a)(2)(B).
[133] §865(c)(3)(B).
[134] §865(d)(1)(A).
[135] §865(d)(1)(B).
[136] §§861(a)(4); 862(a)(4).
[137] §865(d)(3).
[138] §865(e)(1)(A).
[139] §§865(e)(1)(B).
[140] §865(e)(2)(A).
[141] *Id.* (last sentence).
[142] §865(e)(2)(B)(i).
[143] §865(e)(2)(B)(ii).
[144] §865(e)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

7. Sales of Stock in Foreign Affiliated Companies

Special rules apply in the case of sales of stock in foreign affiliated corporations. In particular, if a United States resident sells stock in an "affiliate" which is a foreign corporation, under certain circumstances, any gain from such sale shall be sourced outside of the United States.[145] However, such rule does not apply unless:

(i) the affiliate is engaged in the active conduit of a trade or business,[146] and

(ii) the sale occurs in the foreign country in which the affiliate derived more than 50% of its gross income for the three year period ending with the close of the affiliate's taxable year immediately preceding the year during which such sale occurred.[147]

For these purposes, the term "affiliate" means a member of the same affiliated group within the meaning of §1504(a), applied without regard to §1504(b).[148]

8. Losses from Sales of Personal Property

Section 865 also authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of §865 generally, including regulations relating to the treatment of losses from sales of personal property.[149] In addition, the Treasury Department is authorized to issue regulations applying the rules of §865 to income derived from trading in futures contracts, forward contracts, option contracts, and other instruments.[150]

9. Effective Dates

As a general rule, the amendments discussed above apply to taxable years beginning after December 31, 1986.[151] There is, however, one exception. In the case of any foreign person (other than any controlled foreign corporations), the amendments apply to transactions entered into after March 18, 1986.[152]

10. Treasury Department Study on Sales of Inventory Property

Because the prior title passage rules were generally retained with respect to inventory property, Congress directed the Treasury Department to conduct a study of the source rules relating to sales of inventory property.[153] Such study must be submitted to Congress no later than September 30, 1987, together with such recommendations as Treasury Department deems advisable.[154]

[145] §865(f).
[146] §865(f)(2).
[147] §865(f)(3).
[148] §865(h)(4). For purposes of §865, any possession of the United States is treated as a foreign country. §865(h)(3).
[149] §865(i)(1).
[150] §865(i)(2).
[151] 1986 Act §1211(c)(1).
[152] 1986 Act §1211(c)(2).
[153] 1986 Act §1211(d).
[154] *Id.*

C. Special Rules for Transportation Income

1. Introduction

Under existing law, Regs. §1.863-4 generally allocates transportation services income between United States sources and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the three-mile limit of the United States territorial waters are treated as foreign for purposes of such calculation. Income and losses from transportation that begins and ends in the United States are sourced in the United States.

The United States does not tax foreign persons' earnings from the operation of ships and aircraft registered in foreign countries that grant equivalent tax exemptions to United States citizens and United States corporations. Further, the United States (in contrast to a number of countries) does not impose a gross basis tax on domestic source shipping income of foreign persons.

Section 1212 of the 1986 Act significantly alters these general rules by enacting modifications to the source of income rules related to transportation income and the eligibility requirements for the reciprocal exemption. In addition, this section applies a four-percent "gross basis tax" on United States source transportation income of foreign persons.

2. Source of Transportation Income

Section 1212(a) of the 1986 Act amends §863(c)(2) to provide that, in general, 50% of all transportation income attributable to transportation which begins *or* ends in the United States shall be treated as from sources in the United States.[155] For these purposes, the term "transportation income" means any income derived from, or in connection with, the use of a vessel or aircraft, or the performance of services directly related to the use of a vessel or aircraft.[156]

Section 863 also provides a special rule for personal service income. Specifically, the above-stated rule does *not* apply to any transportation income which is income derived from personal services performed by the taxpayer, *unless* such income is attributable to transportation which begins in the United States and ends in a possession of the United States, or begins in a possession of the United States and ends in the United States.[157]

3. Four Percent Gross Basis Tax

Section 1212(b) of the 1986 Act imposes a new tax on "gross transportation income" by enacting new §887 of the Code. Under §887, in the case of any nonresident alien individual or foreign corporation, a tax equal to four percent of such taxpayer's United States source gross transportation income is imposed for each taxable year of such taxpayer.[158] For these purposes, the term "United States source gross transportation income" means any gross income which is transportation income (as defined in

[155] §863(c)(2)(A). All transportation income that begins *and* ends in the United States is treated as United States source income. §863(c)(1).
[156] §863(c)(3). The term "vessel or aircraft" includes any container used in connection with a vessel or aircraft. *Id.*
[157] §863(c)(2)(B).
[158] §887(a).

§863(c)(3)), to the extent such income is treated as from sources in the United States under §863(c).[159] However, such term does not include any income taxable under §871(b) or §882.[160] Thus, "effectively connected" income is excluded from the gross basis tax under §887.

In that regard, transportation income of any taxpayer shall *not* be treated as "effectively connected" with the conduct of a trade or business within the United States unless:

> (i) the taxpayer has a fixed place of business in the United States involved in the earning of transportation income, and
>
> (ii) substantially all of the United States source gross transportation income of the taxpayer is attributable to regularly scheduled transportation. [161]

In the case of income from the leasing of a vessel or aircraft, if the income is attributable to a fixed place of business in the United States, then such income will satisfy the second requirement noted above.[162]

In order to prevent the imposition of more than one level of tax, new §887 also provides that any income taxable under such section shall not be taxable under §871, §881, or §882.[163]

4. Reciprocal Tax Exemption

Under existing law, the United States does not tax the earnings of foreign persons derived from the operation of ships and aircraft registered in foreign countries that grant equivalent tax exemptions to United States citizens and United States corporations. Section 1212(c) of the 1986 Act modifies such rule by providing that the exemption shall apply to gross income derived by an individual resident of a foreign country from the operation of a ship or ships if such foreign country grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.[164]

Further, the exemption applies to gross income derived by an individual resident of a foreign country from the operation of aircraft, if such foreign country grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.[165] Thus, the reciprocal exemption now turns on whether a foreign person's country of residence provides the equivalent exemption, not on whether the country where the ship or aircraft is registered provides such an exemption.

It should be noted that the income to which the above rules apply includes income which is derived from the rental on a full or bareboat basis of a ship, ships, or aircraft.[166]

Rules similar to those for individuals under §872 are also provided for foreign corporations under §883.[167] In addition, certain additional rules are provided in the case of foreign corporations. More specifically, the reciprocal exemption does not apply to any foreign corporation if 50% or more of the value of the stock of such corporation is owned by individuals who are not residents of such foreign country or another foreign country satisfying the requisite requirements.[168] Further, the rules applicable to shipping operations do not apply to any controlled foreign corporations.[169]

There is, however, an exception to the §883(c) rule for publicly traded corporations. In particular, the general rule of §883(c)(1) does not apply to any foreign corporation:

> (i) the stock of which is primarily and regularly traded on an established securities market in a foreign country in which such corporation is organized, or
>
> (ii) which is wholly owned by another corporation satisfying such requirements and is organized in the same foreign country as such other corporation.[170]

For these purposes, stock owned, directly or indirectly, by or for a corporation, partnership, trust or estate shall be treated as being owned proportionately by its shareholders, partners, or beneficiaries.[171]

5. Effective Dates

In general, the amendments set forth in §1212 of the 1986 Act apply to taxable years beginning after December 31, 1986.[172] Special effective date rules apply, however, with respect to leased property and certain ships leased by the United States Navy.[173]

D. Special Source Rules for Space and Certain Ocean Activities and International Communications Income

Under current law, income derived by United States residents from activities conducted in space or outside the territorial waters of any country generally is treated as foreign source income. Section 1213(a) of the 1986 Act amends §863 of the Code by adding a new subsection (d), related to special source rules for space and certain ocean activities. Section 1213(a) of the 1986 Act also adds a new subsection (e) to §863 of the Code relating to international communications income.

1. Space and Certain Ocean Activities

Under §863(d), any income derived from a space or ocean activity, if derived by a United States person, shall be sourced in the United States.[174] Conversely, any income derived from such activities, if derived by a person other than a United States person, shall be sourced outside the United States.[175] For these purposes, the term "space or ocean activity" means:

---

[159] §887(b)(1).
[160] §887(b)(2).
[161] §887(b)(3).
[162] *Id.*
[163] §887(c).
[164] §872(b)(1).
[165] §872(b)(2).
[166] §872(b)(5).
[167] §883(a)(1), (2).
[168] §883(c)(1).
[169] §883(c)(2).
[170] §883(c)(3).
[171] §883(c)(4).
[172] 1986 Act §1212(f)(1).
[173] 1986 Act §1212(f)(2), (3).
[174] §863(d)(1)(A).
[175] §863(d)(1)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(i) any activity conducted in space, and

(ii) any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States.[176] The term also includes any activity conducted in Antarctica.

On the other hand, the term "space or ocean activity" does *not* include any activity giving rise to transportation income, as defined in §863(c).[177] Further, the term does not include any activity giving rise to international communications income, as defined in §863(e)(2), or any activity with respect to mines, oil and gas wells, or other natural deposits to the extent within the United States or any foreign country or possession of the United States.[178] In that connection, for purposes of applying §638, the jurisdiction of any foreign country shall not include any jurisdiction not recognized by the United States.[179]

2. International Communications Income

Under §863(e), in the case of any United States person, 50% of any "international communications income" shall be sourced in the United States and 50% of such income shall be sourced outside of the United States.[180] With respect to foreign persons deriving international communications income, any such income shall be sourced outside of the United States.[181] The 1986 Act also provides a special rule for income earned by a foreign person that is attributable to an office or fixed place of business in the United States.

More specifically, in the case of any person, other than a United States person, who maintains an office or other fixed place of business in the United States, any international communications income attributable to such office or other fixed place of business shall be sourced in the United States.[182] For purposes of §863(e), the term "international communications income" includes all income derived from the transmission of communications or data from the United States to any foreign country or from any foreign country to the United States.[183]

3. Effective Dates

The amendments added by §1213 of the 1986 Act applies to taxable years beginning after the December 31, 1986.[184]

E. Limitations on the Special Treatment of 80-20 Corporations

1. Introduction

The existing source rules provide that dividend and interest income is generally sourced in the country of the residence of the payor. However, if a United States corporation derives more than 80% of its income from foreign sources, all dividends and interest paid by such corporation are treated as foreign source income. A similar exception applies to interest paid by resident alien individuals who derive more than 80% of their income from foreign sources.[185] Treating such income as foreign source income frequently increases the foreign tax credit limitation of United States recipients and precludes imposition of United States withholding tax for foreign recipients.

Another exception to the residence of the payor rule applies to dividends paid by United States corporations that have elections in effect under §936. Dividends paid by possessions corporations are treated as foreign source income. Other exceptions to the general sourcing rules for interest income function as exemptions from United States tax for limited classes of income earned by foreign persons. For example, interest on United States bank accounts and deposits held by foreign persons is generally treated as foreign source income, and, consequently, is not subject to United States withholding tax.

2. Modifications to the 80-20 Rules

Section 1214 of the 1986 Act amends these existing rules in a number of significant respects. Under new §861(a)(1)(5), interest from a resident alien individual or domestic corporation will be treated as foreign source income only if such individual or corporation satisfies the 80% foreign business requirements set forth in §861(c)(1).[186] Such requirements, in general, are satisfied by an individual or corporation if it is shown to the satisfaction of the Secretary of Treasury that at least 80% of the gross income from all sources of such individual or corporation for the relevant "testing period" is *active* foreign business income.[187]

For these purposes, the term "active foreign business income" means gross income which is derived from sources outside the United States, and is attributable to the active conduct of a trade or business in a foreign country or possession of the United States by the individual or corporation.[188] Further, the term "testing period" means the three year period ending with the close of the taxable year of the individual or corporation immediately preceding the payment. If the individual or corporation has no gross income for such three year period, the "testing period" shall be the taxable year in which the payment is made.[189]

New §861(c) also provides certain "look-through" rules where related persons receive interest.[190] In particular, in the case of interest received by a related person from a resident alien individual or domestic corporation meeting the 80% foreign business requirement test, subsection (a)(l) of §861 applies only to a percentage of such interest equal to the percentage which:

---

[176] §863(d)(2)(A). The term also includes any activity conducted in Antarctica.
[177] §863(d)(2)(B)(i).
[178] §863(d)(2)(B)(ii), (iii).
[179] §863(d)(2)(B) (last sentence).
[180] §863(e)(1)(A).
[181] §863(e)(1)(B)(i).
[182] §863(e)(1)(B)(ii).
[183] §863(e)(2).
[184] 1986 Act §1213(b).

[185] A corporation satisfying the requirements of such exception is generally referred to as an "80-20" company, and an individual who satisfies such exception is frequently referred to as an "80-20" individual.
[186] §861(a)(1)(B).
[187] §861(c)(1)(A).
[188] §861(c)(1)(B).
[189] §861(c)(1)(C).
[190] §861(c)(2).

(i) the gross income of such individual or corporation for the testing period from sources outside the United States, is of

(ii) the total gross income of such individual or corporation for the testing period.[191]

For purposes of the look-through rules, the term "related person" has the same meaning as such term is given in §954(d)(3), except that (i) such subsection is applied by substituting the "individual or corporation making the payment" for "control foreign corporation" each place that such term appears, and (ii) such section is applied by substituting "10%" for "50%" each place such percentage appears.[192]

With respect to the treatment of dividends paid by 80-20 corporations, §1214(b) of the 1986 Act amends §861(a)(2)(A) to provide that dividends paid by a domestic corporation shall be United States source income except if such domestic corporation has an election in effect under §936.[193] The effect of such amendment is to repeal the special sourcing rule under existing law for dividends paid by 80-20 companies. Further, the 1986 Act amends §861 to provide that if a foreign corporation has no gross income from any source for the three year period specified in §861(a)(2)(B), the requirements of the subsection shall be applied with respect to the taxable year of such corporation in which the payment of the dividend is made.[194]

Section 1214 of the 1986 Act also amends §§871 and 881 to provide that no withholding tax is to be applied with respect to certain interest and dividends.[195] More specifically, §871 is amended by adding a new subsection (i). The new sub section provides that no tax shall be imposed under §871 on any amount described in §871(i)(2).[196] The amounts described therein include:

(i) Interest on deposits, if such interest is not effectively connected with the conduct of a trade or business within the United States.

(ii) A percentage of any dividend paid by a domestic corporation meeting the 80% foreign business requirements test.

(iii) Income derived by foreign central bank of issue from bankers' acceptances.[197]

For these purposes, the term "deposits" means amounts which are deposits with persons carrying on the banking business, and deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under federal or state law, but only to the extent that amounts paid or credited on such deposits or accounts are deductible under §591.[198] The term "deposits" also means amounts held by an insurance company under an agreement to pay interest thereon.[199]

Section 1214(c) of the 1986 Act also amends §881, relating to foreign corporations, to provide that no tax shall be imposed under §881 on any amount described in §871(i)(2). In addition, conforming amendments are made under §§1441 and 6049(b)(5) to take into account the changes enacted in §871(i)(2).[200]

An example of the following provisions follows.

Example: Assume that a United States corporation and an unrelated foreign corporation jointly incorporate a second United States corporation to operate a mining business in a foreign country. The second United States corporation earns $450 of income, all of which is foreign source, from the mining operations in its first year and $50 of United States source income from investments in the United States. At the end of the year, the second corporation distributes a $100 dividend to each of its two shareholders. The first United States corporation in turn distributes $50 to its shareholders, all of whom are foreign residents. The new provisions treat the $100 dividend to the first United States corporation as entirely United States source. The $100 dividend to the foreign shareholder is treated as 90% foreign source and as 10% United States source.

In the above example, since the United States foreign corporation owns a controlling interest in the second United States corporation, the second corporation's active foreign business is attributed to the first corporation. Therefore, assuming that the first corporation has no other interest, the first corporation satisfies the new 80% active foreign business requirement test. Even though the dividend is treated as United States source income, the dividend from the second corporation retains the same character as the income of the second corporation in determining the source of dividends paid by the first corporation.

Accordingly, under the new section, since the first corporation in the above example has no other income, 90% of the first corporation's dividends paid to its shareholders are foreign source and 10% are United States source. If, however, for example, the first United States corporation had $13 or more of non-foreign active business income in that year, the first corporation would *not* satisfy the 80% foreign active business requirement test, and, therefore, its dividend payments would all be U.S. source.
and would, therefore, pay all United States source dividends.

The amendments discussed above generally apply to payments made after December 31, 1986.[201] There are, however, certain special rules for payments of interests and dividends, as well as two sets of transitional rules, for years after 1987 and years before 1988. For example, in applying the amendments made by §1214 of the 1986 Act to any payment made by a corporation in a taxable year beginning

[191] §861(c)(2)(A).
[192] §861(c)(2)(B).
[193] §861(a)(2)(A).
[194] §861(a)(2)(B).
[195] 1986 Act §1214(c).
[196] §871(i)(1).
[197] §871(i)(2).
[198] §871(i)(3)(A), (B).
[199] §871(i)(3)(C).
[200] 1986 Act §1214(c)(2).
[201] 1986 Act §1214(d)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

after December 31, 1987, the "testing period" for purposes of §861(c) shall *not* include any taxable year beginning before January 1, 1987.[202]

F. Allocation and Apportionment of Interest and Other Expenses to Foreign Source Income

1. Introduction

Under the current Treasury Regulations, taxpayers generally allocate interest and other expenses between gross United States and gross foreign source income on a separate, company-by-company basis, even if such companies are members of the same affiliated group. It has been argued that the separate company allocation rule conflicts with a Court of Claims case decided under the law in effect prior to the effective date of the Treasury Regulations, which case indicates that expenses that are not definitely allocable against United States and foreign gross income should be deducted from gross income on a consolidated group basis.[203] *See* Conference Report at II-604.

Generally, under the Treasury Regulations, interest expense is allocated between United States and foreign income on the basis of the value of the taxpayer's assets that generate United States and foreign source income. For affiliates, only stock basis is taken into account. In limited cases, interest on non-recourse debt is directly allocated against the income from the asset financed by such debt. In addition, optional gross income methods for apportioning interest expense are also available under the Treasury Regulations.

Further, taxpayers generally may take into account tax exempt income and assets in allocating deductible interest and other expenses. Since tax exempt income and interest are generally United States-based, taxpayers frequently derive a second tax benefit from ownership of tax exempt assets, *i.e.*, higher foreign income and hence a higher foreign tax credit limitation.

Section 1215 of the 1986 Act amends §864 of the Code by adding a new subsection (e) relating to rules for allocating interest and other expenses to foreign source income.

2. New Rules for Allocating Interest and Other Expenses

Under new §864(e), the taxable income of each member of an affiliated group from sources outside the United States shall be determined by allocating and apportioning interest expense for each member as if all members of such group were a single corporation.[204] For these purposes, all allocations and apportionments of interest expense shall be made on the basis of assets rather than gross income.[205] Thus, the so-called "gross income method" may no longer be used for allocating or apportioning interest.

Further, for purposes of allocating and apportioning any deductible expense, any tax-exempt asset (and any income from such an asset) shall not be taken into account.[206] In addition, a similar rule shall apply in the case of any dividend for which a deduction is allowable under §§243 or 245(a) and any stock the dividends on which would be so deductible and would not be qualifying dividends.[207]

New §864(e) also provides rules relating to the basis of stock in certain corporations that is adjusted for earnings and profit changes.[208] In particular, for purposes of allocating and apportioning expenses on the basis of assets, the adjusted basis of any asset which is stock in a corporation which is not included in the "affiliated group" and in which members of the affiliated group own 10% of more of the total combined voting power of all classes of stock entitled to vote in such corporation shall be:

> (i) increased by the amount of the earnings and profits of such corporation attributable to such stock and accumulated during the period the taxpayer held such stock, or
>
> (ii) reduced (but not below zero) by any deficit in earnings and profits of such corporation attributable to such stock for such period.[209]

For these purposes, the term "affiliated group" has the meaning given such term by §1504 of the Code, determined without regard to §1504(b)(4).[210]

In addition, certain special rules are applied with respect to financial institutions. For these purposes, a corporation is considered a financial institution if such corporation is a financial institution described in §§581 or 591, the business of such financial institution is predominantly with persons other than related persons or their customers, and such financial institution is required by state or federal law to be operated separately from any other entity which is not such an institution.[211] Any such corporation shall be treated as an includible corporation for purposes of §1504 only for purposes of applying such section separately to corporations so described.[212]

Finally, expenses other than interest which are not directly allocable and apportioned to any specific income producing activity shall be allocated and apportioned as if all members of the affiliated group were a single corporation.[213] Thus, such expenses can no longer be allocated and apportioned on a separate, company-by-company basis.

3. Treasury Regulations

Section 864(e)(7) provides that the Treasury Department shall prescribe regulations necessary or appropriate to carry out §864(e), including regulations relating to the resourcing of income of any member of an affiliated group, and the direct allocation of interest expense incurred to

[202] 1986 Act §1214(d)(3)(B).
[203] *See International Telephone and Telegraph Corp. v. United States*, 2 USTC ¶9649 (1979).
[204] §864(e)(1).
[205] §864(e)(2).
[206] §864(e)(3).
[207] *Id.*
[208] §864(e)(4).
[209] §864(e)(4)(A), (B).
[210] §864(e)(5).
[211] §864(e)(5)(C).
[212] §864(e)(5)(B).
[213] §864(e)(6).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

carry out an integrated financial transaction.[214] Further, the Treasury Department is authorized to prepare regulations relating to the apportionment of expenses allocated to foreign source income among the members of an affiliated group and the various categories of income described in §904(d)(1).[215]

4. Effective Dates and Transitional Rules

New §864(e) is generally effective for taxable years beginning after December 31, 1986.[216] However, the immediate impact of §864(e) is substantially ameliorated by transitional rules in §1215(c)(2) of the 1986 Act. The transitional rules provide different applicable periods for different subsections of new §864(e).

a. General Three Year Rule

In the first three taxable years of the taxpayer beginning after December 31, 1986, §864(e) will apply only to the following percentages of the interest expenses paid or accrued during the taxable year:

First year: 25% of "Transition Rule Current Debt" will be subject to the new regime; 75% will not be subject to such rules. Debt *in excess* of Transition Rule Current Debt will be 100% subject to the new rules.[217]

Second year: 50% of Transition Rule Current Debt will be subject to the new rules; 50% will not.

Third year: 75% of Transition Rule Current Debt will be subject to the new rules; 25% will not.[218]

b. Special 4 and 5 Year Transition Rules for Consolidated Pool Calculations

In addition, there are two sub-transition rules affecting only that portion of Transition Rule Current Debt subject to apportionment on a consolidated pool basis under §864(e)(1). The first such rule deals with a "debt increase" occurring from January 1, 1984 through May 28, 1985. ("1984-1985 Debt Increase"). The second rule deals with a debt increase occurring in 1983. Debt not assigned to the consolidated pool will nonetheless remain partially subject to the new rules in the separate taxpayer to whom the debt belongs. All debt in the consolidated pool is 100% subject to the new rules.

(1) January 1, 1984—May 28,1985 Debt Increase

Debt equal to the following portions of Transition Rule Current Debt is allocated to the consolidated pool, in the case of the first five taxable years of the taxpayer beginning after December 31, 1986:

First year: 16⅔% of "1984-85 Debt Increase"
Second year: 33⅓% of "1984-85 Debt Increase"
Third year: 50% of "1984-85 Debt Increase"
Fourth year: 66⅔% of "1984-85 Debt Increase"
Fifth year: 83⅓% of "1984-85 Debt Increase"

The remainder, if any, in each year is left in the separate taxpayer's pool, to be apportioned by that taxpayer under the new enhanced asset method.[219]

(2) 1983 Debt Increase

Any Transition Rule Current Debt in excess of the 1984—1985 Debt Increase, in the case of the first four taxable years of the taxpayer beginning after December 31, 1986, is next allocated to the consolidated pool, to the extent of the following percentages of the "1983 Debt Increase":

First year: 20% of "1983 Debt Increase"
Second year: 40% of "1983 Debt Increase"
Third year: 60% of "1983 Debt Increase"
Fourth year: 80% of "1983 Debt Increase"

The remainder, if any, is left in the separate taxpayer's pool to be allocated under the new regime's enhanced asset method.[220]

In addition, there are special transitional rules for specific corporations. For example, there are special rules for a certain financial corporation incorporated in Delaware on August 20, 1959, and a subsidiary incorporated on February 11, 1975 with Japanese yen notes and Swiss franc bonds currently outstanding.[221]

G. Allocation and Apportionment of Research and Experimental Expenditures

The current Treasury Regulations require taxpayers with foreign source income from products in a product area in which the taxpayer does United States research to allocate part of their research expense to foreign source income.[222] As part of the Economic Recovery Tax Act of 1981, Congress suspended such rule for two years, so that all United States research expenditures generally offset United States source income. In the Tax Reform Act of 1984, Congress extended the moratorium for an additional two years.

The House Bill provided that taxpayers were required to apportion 50% of their United States-incurred research expense to domestic source income, and to apportion the remainder on the basis of gross sales or gross income. The Senate Amendment followed the House Bill, except it required taxpayers to apportion 75% of their United States-incurred research expense to domestic source income, and to apportion the remainder on the basis of gross sales or gross income.

Section 1216 of the 1986 Act enacts a one-year moratorium on Regs. §1.861-8(e) which generally follows the House Bill and provides that, notwithstanding §864(e):

(i) 50% of all amounts allowable as a deduction for qualified research and experimental expenditures shall be apportioned to income from sources within the United States and deducted from such income in deter-

[214] §864(e)(7)(A), (B).
[215] §864(e)(7)(C).
[216] 1986 Act §1215(c)(1).
[217] The term "Transition Rule Current Debt" is not defined in the Code or the 1986 Act, but is defined herein as an amount of *current debt equal to or less than* debt existing on November 16, 1985.
[218] 1986 Act §1215(c)(2)(A).
[219] 1986 Act §1215(c)(2)(B)(i).
[220] 1986 Act §1215(c)(2)(B)(ii).
[221] 1986 Act §1215(c)(4), (5).
[222] Regs. §1.861-8(e)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

mining the amount of taxable income from sources within the United States, and

(ii) the remaining portion of such amounts shall be apportioned on the basis of gross sales or gross income.[223]

However, such rule does not apply to any expenditures described in Regs. §1.861-8(e)(3)(i)(B), relating to research undertaken solely pursuant to legal requirements.

For these purposes, the term "qualified research and experimental expenditures" means amounts (i) which are research and experimental expenditures within the meaning of §174, and (ii) which are attributable to activities conducted in the United States.[224] The new rules are applicable only to taxable years beginning after August 1, 1986, and on or before August 1, 1987.[225]

Thus, for the relevant time period, 50% of all qualified research and experimental expenditures must be apportioned to United States source income and must be deducted from such income in determining the amount of taxable income from sources within the United States. The remaining 50% is then apportioned on the basis of gross sales or gross income.[226]

[223] 1986 Act §1216(a).

[224] 1986 Act §1216(b).
[225] 1986 Act §1216(c).
[226] 1986 Act §1216(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 62

NEW BRANCH PROFITS TAX

George B. Delta, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

Section 1241 of the Tax Reform Act of 1986 (the "TRA") adds §884 to the newly designated Internal Revenue Code of 1986, creating a branch profits tax, repeals the sourcing rules for interest in §§861(a)(1)(C) and (a)(1)(D), and modifies the sourcing rule for dividends in §861(a)(2)(B).[1] As a result, the second level withholding tax for interest is eliminated except in the case of certain tax treaties, the threshold for the application of the second level withholding tax on dividends is lowered, and the branch level tax is imposed.

II. Present Law

Under present law, the United States seeks to tax foreign corporations that operate in the United States in the same way as U.S. corporations that operate in the United States. Thus, if the recipient of dividends and interest from a foreign corporation is a U.S. person, the United States imposes a tax at the regular graduated tax rates. If the recipient of the dividends and interest is a foreign person, however, taxation becomes more complex.

A U.S. corporation that pays dividends to a foreign person not engaged in a trade or business within the United States must withhold tax at the rate of 30 percent, absent a contrary treaty provision.[2] The United States imposes the tax at a flat 30% rate because it is not feasible to collect a graduated tax from foreign persons who may have minimal contacts with the United States. Bilateral income tax treaties reduce the withholding tax on dividends paid to residents of the treaty country to as little as 5% and also reduce or eliminate the tax on interest paid to residents of the treaty country.

Similarly, a foreign corporation, most of whose operations are in the United States, that pays dividends or interest of the types that are taxable if paid by a U.S. corporation to a foreign person, must withhold a portion of such payments. A foreign corporation is liable for this second level withholding tax only when more than half of its gross income for the 3-year period ending with the close of the taxable year preceding the payment of the interest or the declaration of the dividends is effectively connected with a U.S. trade or business.[3] The second level withholding tax (or lower treaty rate) applies to the allocable portion of the interest or dividend payments attributable to income of the foreign corporation that is effectively connected with its U.S. trade or business. The second level withholding tax exists primarily because its elimination would give an unfair advantage to a corporation which conducts substantially all of its business in the United States. Moreover, the second level withholding tax also attempts to treat payments by foreign corporations with significant operations in the United States like payments by U.S. corporations.

III. Detailed Analysis

A. Tax Base — The Dividend Equivalent Amount

New §884 substitutes a branch level tax at the rate of 30% on the "dividend equivalent amount" in place of the second level withholding tax. The "dividend equivalent amount" is the foreign corporation's earnings and profits that are effectively connected with the conduct of a trade or business in the United States for the taxable year, with two adjustments.[4] This tax base ("dividend equivalent amount") is adjusted as follows:

(1) it is reduced by any increase in "U.S. net equity"; and

(2) it is increased by any decrease in "U.S. net equity."[5]

The increases and decreases in "U.S. net equity" are calculated by comparing the net equity at the close of the taxable year with the net equity at the close of the previous taxable year.[6] "U.S. net equity" is defined as U.S. assets, reduced (including below zero) by U.S. liabilities. The term U.S. assets is defined as the money and the aggregate adjusted bases of property of the foreign corporation that is treated as effectively connected with the conduct of a trade or business in the United States under regulations prescribed by the Secretary of Treasury. The adjusted tax basis of any property shall be its adjusted basis for purposes of computing earnings and profits.[7] The term U.S. liabilities is defined as the liabilities of the foreign corporation that are treated as effectively connected with the conduct of a trade or business in the United States under regulations prescribed by the Secretary of Treasury.[8] Such regulations are to be consistent with the principles used in allocating

[1] Current §884 of the Code is redesignated as §885. The Internal Revenue Code of 1986 is referred to by section only.

[2] *See, e.g.*, §§871(a)(1)(A) and 881(a)(1).

[3] §§861(a)(1)(C), 861(a)(1)(D), 861(a)(2)(B), 871(a)(1)(A), and 881(a)(1) prior to the passage of the TRA.

[4] §§884(a) and (b).

[5] §§884(b)(1) and (2).

[6] *Id.*

[7] §884(c)(2)(A).

[8] §884(c)(2)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

interest deductions under §882(c)(1).[9] U.S. assets include cash necessary to meet the day-to-day operating requirements of the branch, receivables from the sale of goods or services, inventories, property, plant, and equipment used in the business, investments (as long as the income from such investments is effectively connected with the conduct of a U.S. trade or business), and other assets necessary to operate the business.[10] U.S. liabilities include the day-to-day payables and short-term obligations, long-term obligations incurred to purchase assets that are used in the business, and other liabilities necessary to meet business obligations.[11]

Since the tax base is computed with respect to the earnings and profits of the branch that are effectively connected with the conduct of a U.S. trade or business, the computation of net equity, as the base used to determine the amount of the deemed remittances of the profits of the branch, is also based on the value of the branch's assets and liabilities for purposes of earnings and profits. If the value for purposes of earnings and profits is different than the adjusted tax basis, the former value shall govern. Therefore, if a branch claims accelerated depreciation on its assets in calculating taxable income, it will be required to calculate net increases or decreases in equity by using the basis of the assets for earnings and profits purposes.[12] Because the tax base should be decreased for increases in net U.S. equity, the Conference Report also provides that the tax base should be decreased in stock acquisition cases if the branch tax would not have been imposed had assets rather than stock been acquired. Treasury regulations may provide, therefore, that where a branch acquires control of a U.S. corporation with its profits, it may be inappropriate to impose the branch tax.[13] The tax base is reduced by the increase in "U.S. net equity," because of the assumption that such increase in net equity results from a reinvestment of current after-tax earnings which should not be taxed again. Similarly, the tax base must be increased by the decrease in "U.S. net equity," because of the assumption that such decrease results from a disinvestment of previously reinvested earnings which should be taxed.[14] Thus, a tax is due upon subsequent disinvestment of reinvested earnings.[15]

It would appear that, under a literal reading of §884, the branch tax would be due upon liquidation of the foreign corporation or upon termination of its U.S. activities. The Service has announced, however, that pursuant to its authority to prescribe regulations under §884, it will provide that no branch tax will be imposed for the year in which a foreign corporation completely terminates its U.S. trade or business.[16] Subject to an anti-abuse rule, a foreign corporation that terminates its U.S. trade or business (for example, by selling all of its U.S. trade or business assets and investing the proceeds in U.S. obligations) will not have a decrease in U.S. net equity as of the end of the taxable year nor will it have income that is effectively connected to the conduct of a U.S. trade or business for purposes of the branch tax. Therefore, the foreign corporation will not be liable for the branch tax.

Comment: For purposes of Notice 86-17, a corporation with more than one U.S. branch will be deemed to have a single U.S. trade or business. Thus, a foreign corporation must cease all activities in all of its branches in order to terminate completely its U.S. trade or business and avoid the branch profits tax by relying on Notice 86-17. Under the anti-abuse rule, a foreign corporation will be subject to the branch profits tax nonetheless, if it completely terminates its U.S. trade or business and then conducts a U.S. trade or business, directly or through a related person, with the assets of the terminated trade or business, or reinvests any of the proceeds from the sale of the assets of the terminated trade or business in a U.S. trade or business.

Observation: Regulations under §884 will also provide that the incorporation of all of the U.S. trade or business activities of a foreign corporation into a wholly owned U.S. subsidiary in a §351 transaction will not be treated as a decrease in U.S. net equity of the foreign corporation. As a result, the dividend equivalent amount will not be increased, and no branch tax will be imposed.[17]

The "dividend equivalent amount" (increased or decreased by net U.S. equity) is based on the earnings and profits of the branch, to achieve greater parity between the remittance of branch profits and the distribution of the earnings of a subsidiary.[18] Thus, the tax base is reduced by Federal and foreign income taxes, by capital losses not allowed in computing taxable income, and by any other adjustments that affect the amount of earnings that could be repatriated as a dividend if the branch operated as a corporation.[19] The earnings and profits of the branch are measured pursuant to general Code principles, but are limited to the activities of the branch.[20] Since the branch profits tax applies to earnings and profits that are effectively connected with a U.S. trade or business, the tax applies, for example, to foreign corporations that are partners in a partnership that derives effectively connected income and to foreign corporations that own vessels and aircraft that generate effectively connected income.[21]

Because the computation of earnings and profits is to be consistent with the computation of a subsidiary's earnings and profits, the branch's earnings and profits include income that would be effectively connected with the conduct of a U.S. trade or business if such income were taxable. Thus, tax exempt interest received or accrued by the branch is included in the earnings and profits limitation, even though such interest is not included in the branch's income that is effectively connected with the conduct of a U.S. trade or business.[22] Moreover, current earnings that are not reinvested in a branch's trade or

[9] §884(c)(2)(C); *See* Treas. Regs. §1.882-5.
[10] S. Rep. No. 313, 99th Cong., 2d Sess. 404 (1986) ("S. Rep.").
[11] *Id.*
[12] §884(d)(1); Conf. Rep. No. 841, 99th Cong., 2d Sess. II-648 (1986) ("Conf. Rep.").
[13] §884(b)(1); Conf. Rep. at II-648.
[14] *See* S. Rep. at 403; Conf. Rep. at II-648.
[15] §884(b)(2); S. Rep. at 403; Conf. Rep. at II-648.
[16] Notice 86-17, I.R.B. 1986-52 (Dec. 29, 1986).
[17] *Id.*
[18] §884(b); Conf. Rep. at II-647.
[19] S. Rep. at 403; Conf. Rep. at 647.
[20] *Id.*
[21] S. Rep. at 403.
[22] S. Rep. at 403; Conf. Rep. at II-647.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

business assets are subject to the tax, even though the branch has incurred deficits in prior years. Consistent with the taxation of a subsidiary's distributions, the dividend distributions of a foreign corporation during a year do not reduce the earnings and profits of a branch for purposes of determining the tax base of the branch.[23]

New §884 explicitly excludes five items from income in determining effectively connected earnings and profits of a branch:

(1) certain earnings derived by foreign sales corporation (income described in §§921(d) and 926(b));

(2) earnings derived by foreign transportation carriers that are exempt from U.S. tax pursuant to treaty or reciprocal exemption;

(3) earnings derived from the sale of any interest in U.S. real property holding corporations;

(4) earnings derived by certain captive insurance companies that elect to treat their income as effectively connected with a trade or business; and

(5) earnings derived by corporations satisfying certain ownership and income requirements that are organized in certain U.S. possessions (described in §881(b)).[24]

The Conference Report states at II-648 that the exclusion for earnings and profits of a U.S. possessions corporation is intended to be mirrored to prevent the application of the branch tax to U.S. corporations operating in U.S. possessions.

B. Branch Tax — The Branch Level Interest Tax

Congress has also sought to equalize the taxation of branch interest with the taxation of a subsidiary's interest.[25] Thus, any interest paid by a branch of a foreign corporation engaged in a trade or business in the United States will be treated as if it were paid by a U.S. corporation for purposes of §§871, 881, 1441, and 1442.[26] In addition, to the extent the amount of interest allowable as a deduction under §882 in computing the effectively connected taxable income of the foreign corporation exceeds the interest that is deemed paid under the provisions enumerated in the preceding sentence, such excess interest shall be treated as interest paid by the branch to its foreign parent on the last day of the foreign corporation's taxable year.[27] The rate of tax on branch level interest is 30%, absent a treaty reduction of the tax rate.[28]

The Secretary has authority to promulgate regulations to clarify the scope of the branch level tax on interest. The Conference Report states that the regulations may provide that where the indebtedness of the home office is attributed to the branch, the excess interest is treated as incurred on each type of external borrowing by the foreign corporation and determined by reference to the relative principal amounts of each type of external borrowing, taking into account the average interest rate on each such type of borrowing.[29] For example, in the case of a bank, the excess interest will not necessarily be treated as interest paid on a bank deposit. The Conference Report also questions the legitimacy of any attempts between a branch and its foreign parent, or between two branches, to establish bona fide debtor-creditor relations, because only one legal entity is involved. If a branch succeeds in structuring its interbranch loans artificially in a manner different from its external liabilities, it will be able to reduce or eliminate the tax on its excess interest. The regulations are expected to address this concern. Should companies be able nonetheless to establish bona fide debtor-creditor relationships, the regulations may treat excess interest as an interbranch loan.[30]

C. Relationship with Tax Treaties

A unique aspect of the branch profits tax imposed by §884 is its interaction with U.S. bilateral tax treaties. These tax treaties fall into three different categories, and §884 treats each category differently. The three categories are treaties that prevent the imposition of the branch tax, treaties that permit the imposition of a branch tax, and treaties that are silent on the issue.

Newer treaties and those based on the United States 1981 Model Tax Treaty contain nondiscrimination clauses that prohibit the branch tax, because the imposition of such tax, which is not incurred by U.S. corporations, results in more burdensome taxes than those imposed by the United States on U.S. corporations. Thus, the Conference Report states that the Treasury Department interprets Article 24(3) (and similar provisions in other treaties) of the United States 1981 Model Tax Treaty to preclude the branch profits tax.[31] The TRA provides that if such treaty prohibits the branch tax, the branch tax will not apply.[32] If the treaty allows the second level withholding tax on dividends, the withholding tax will apply as under prior law, instead of the branch tax.[33] The report of the Senate Finance Committee states that the Treasury Department interprets Article 10(5) (and similar provisions in other treaties) of the United States 1981 Model Tax Treaty to permit the imposition of a second level dividend tax by the United States.[34] Thus, for example, if the withholding tax on dividends applies when the foreign corporation derives 50% or more of its income from sources within the United States, and the foreign corporation does derive 50% or more of its income from the United States, the second level withholding tax will apply under the terms of the treaty. If the foreign corporation does not derive 50% of its income from U.S. sources, however, neither the branch tax nor the withholding tax will apply.[35]

Treaty benefits will be disallowed (notwithstanding the fact that a treaty does not allow the branch tax) if the foreign corporation seeking to take advantage of such benefits is treaty shopping. Treaty shopping exists (i) if

[23] Conf. Rep. at II-647.
[24] §884(d)(2); Conf. Rep. at II-647-48.
[25] Conf. Rep. at II-648.
[26] §884(f)(1)(A).
[27] §884(f)(1)(B).
[28] §884(f); Conf. Rep. at II-648.
[29] Conf. Rep. at II-649.
[30] *Id.*
[31] Conf. Rep. at II-650.
[32] §884(e)(1)(A). *See* S. Rep. at 404; Conf. Rep. at II-650.
[33] §884(e)(1)(B). *See* S. Rep. at 405.
[34] S. Rep. at 405.
[35] §884(e)(1)(A); S. Rep. at 405.

more than 50% in value of the stock of the foreign corporation seeking to take advantage of the tax treaty is beneficially owned, actually or constructively under §958, by persons who are not residents of the foreign country party to the treaty, or (ii) if 50% or more of the foreign corporation's income is used, directly or indirectly, to meet liabilities to persons who are not residents of the foreign country party to the treaty or the United States.[36] If the foreign corporation's stock is primarily and regularly traded on an established securities exchange in the country under whose treaty it claims benefits as a resident, the TRA provides that it shall be considered a resident of that country for purposes of §884, notwithstanding the general stock ownership rule.[37] In addition, if the foreign corporation's parent is organized in the same country as the foreign corporation, the subsidiary corporation is wholly owned by the parent (directly or indirectly), and the parent corporation's shares are primarily and regularly traded in that country, the subsidiary corporation will also be considered a resident of that foreign country for purposes of the country's treaty with the United States.[38] The Secretary of Treasury has authority to prescribe regulations that treat a corporation as a resident of a foreign country, if such corporation meets any requirements that the Secretary establishes to ensure that individuals who are not residents of such foreign country are not treaty shopping.[39]

In a treaty shopping situation, where the treaty allows the second level withholding tax on dividends but disallows the branch tax, the withholding tax will apply under the terms of the treaty, if the withholding tax is triggered. For example, if the withholding tax on dividends applies when the foreign corporation derives 50% or more of its income from sources within the United States, and the foreign corporation does derive 50% or more of its income from the United States, the second level withholding tax will apply under the terms of the treaty. In the event that the foreign corporation in the above example does not derive 50% of its income from U.S. sources, however, it will not be subject to the withholding tax, and, therefore, the branch tax will apply.[40] Treaties with Belgium, Italy, Japan, Korea, and the United Kingdom prohibit the branch tax.

Bilateral treaties that allow the imposition of the branch tax are harmonious with §884. If such treaties reduce the rate of the branch tax, such reduced rate will apply.[41] Treaties with Australia, Barbados, Canada, France, New Zealand, Poland, Rumania, South Africa, the U.S.S.R., and Trinidad and Tobago allow a branch tax. In treaty shopping cases, however, the 30% statutory rate will apply.[42] Finally, if the treaty between the United States and the country in which the corporation resides permits a branch profits tax, but contains a different calculation of the tax, or subjects the branch tax to restrictions that are not in §884, the treaty will apply, unless the corporation is treaty shopping.[43]

Example: Article X(6) of the United States tax treaty with Canada provides a different calculation of the branch profits tax. Under the Canadian treaty, a branch profits tax is imposed at the rate of 10% on the earnings of the branch (permanent establishment). Earnings consist of business profits (including gains from the sale of property in the country where the branch is located, if such property forms part of the business property of the branch), less the sum of (a) business losses attributable to such branch, (b) all taxes imposed by the country where the branch is located (other than the branch tax), (c) the profits of the branch that are reinvested in the country where the branch is located, and (d) five hundred thousand Canadian dollars ($500,000) or the equivalent amount in United States dollars.[44] Unless the Canadian corporation is treaty shopping, this treaty calculation of the branch tax will apply.

If a treaty between the United States and the country in which the foreign corporation resides does not specifically provide for a branch tax, but does otherwise permit such a tax, the treaty's direct investment dividend rate will apply to the branch tax base.[45] If the corporation is treaty shopping, the 30% rate under §884(a) will be used.[46] Treaties with Austria, Denmark, Greece, Ireland, Luxembourg, the Netherlands Antilles, Pakistan, Sweden, Switzerland, and West Germany appear to fall into the category of treaties that do not specifically provide for the branch tax, but do otherwise permit such tax.

A treaty may modify or eliminate the branch tax on excess interest as defined in §884(f)(1)(B), provided there is no treaty shopping.[47] In determining whether a treaty reduces or eliminates the branch tax on interest, the applicable treaty is generally the one between the United States and the country of the corporation's home office. As with the branch tax on the dividend equivalent amount, any treaty benefits are subject to the treaty shopping prohibition of §884(e)(3)(B).[48] In the case of withholding tax on interest actually paid by a branch, §884 effectively treats the branch as a U.S. corporation; therefore, the appropriate treaty is the one between the United States and the country of the foreign recipient. Treaty benefits will be unavailable in instances of treaty shopping.

D. Coordination with the Second Level Withholding Tax

The TRA revokes the sourcing rules for interest found in §§861(a)(1)(B) and (C). In addition, the TRA reduces the threshold at which the second level withholding tax on dividends applies.[49] As a result, dividend income will be U.S. source if at least 25% of the foreign corporation's gross income from worldwide sources is effectively connected with with the conduct of a trade or business within the United States during the 3-year period ending on the close

[36] §884(e)(4)(A); S. Rep. at 405; Conf. Rep. at II-649.
[37] §884(e)(4)(B)(i).
[38] §884(e)(4)(B)(ii).
[39] §884(e)(4)(C).
[40] §884(e)(1)(B); S. Rep. at 405.
[41] §884(e)(2)(A)(i); S. Rep. at 403.
[42] §884(e)(4); S. Rep. at 403.
[43] §§884(e)(2) and 884(e)(4); S. Rep. at 403-04.
[44] Article X(6)(a), (b), (c), and (d), Convention with Respect to Taxes on Income and on Capital, August 16, 1984, United States-Canada, 1 Tax Treaties (P-H) ¶¶22,040, 22,065
[45] §884(e)(2)(ii); S. Rep. at 403-04.
[46] §§884(e)(2)(A)(ii) and (e)(4).
[47] §884(f)(1). *See* III, B, above for a discussion of excess interest.
[48] *Id.*
[49] TRA §1241(b)(1)(B) and (b)(2).

of the taxable year preceding the payment of the dividends.[50]

The TRA does not allow a tax credit for the branch profits tax. Instead, the TRA expands the current deduction for dividends received from a foreign corporation. Consequently, if a corporation is subject to the branch profits tax for any taxable year, any second level withholding tax imposed by §§871(a), 881(a), 1441, or 1442 will not apply to any dividends paid by such corporation for the taxable year, though the branch tax for the taxable year may be zero.[51] Thus, if a branch reinvests its after-tax earnings in a trade or business during a taxable year so that no branch tax is due that year, but the branch's business income exceeds 25% of the foreign corporation's total income and the corporation distributes dividends during that year, no withholding tax applies. Only if the tax treaty of the country where the foreign corporation resides precludes the branch tax and permits the withholding tax will the withholding tax apply.[52] If the foreign corporation is treaty shopping, however, it cannot claim any benefits under the treaty with respect to dividends that the foreign corporation pays and on which it must withhold under §§1441 or 1442, nor can it claim treaty benefits with respect to dividends that it receives, if such dividends meet the new 25% threshold of §861(a)(2)(B).[53]

Under present law, if a foreign corporation's U.S. subsidiary sells real estate, such sale may be subject to a corporate level tax as well as a tax on the amount that is repatriated as a dividend. The Conference Report makes it clear that the withholding tax on dividends will apply in addition to the branch profits tax in instances where the branch sells real property and pays a dividend to its parent corporation.[54] The TRA does not modify the portion of dividends treated as U.S. source.

E. Regulations

Section 884(g) grants the Secretary of Treasury authority to prescribe regulations necessary to carry out the purposes of the statute. The regulations are to address several potential abuse situations. One such situation is the temporary increase in the "U.S. net equity" of a branch at the end of the year, in order to decrease the branch profits tax. Other such abuses are the use of back-to-back loans by persons who are not residents of the treaty country to avail themselves of benefits under the treaty, and the improper characterization of interbranch funds, by both treaty and nontreaty residents, to avoid U.S. tax. Congress has instructed the IRS to collapse back-to-back loans, and, if the ultimate recipient is not protected by a treaty, he will be subject to U.S. tax.[55] Similarly, the IRS will scrutinize interbranch transactions to make sure that they have substance.[56] Regulations are also to address the extent to which a decrease in "U.S. net equity" may not indicate that a branch has remitted its profits during the taxable year. The Conference Report contains a warning to taxpayers that the tax-writing committees of Congress will monitor collections and compliance with the new provisions to ensure that there are no abuses. Congress intends to cure any such abuses with additional legislation.[57]

F. Effective Date

Section 1241 of the TRA is effective for taxable years beginning after December 31, 1986.[58]

IV. Consequences of the Branch Profits Tax

A. Interaction and Conflict with Treaties

There is a conflict between the second level branch tax and the nondiscrimination clauses of some recent U.S. tax treaties. Treaties with Belgium, Italy, Japan, Korea, and the United Kingdom clearly preclude the additional level of U.S. tax (the branch profits tax) on permanent establishments in the United States of the five treaty countries, because the imposition of such tax, which is not incurred by U.S. corporations, results in more burdensome taxes than those imposed by the United States on U.S. corporations. While the second level branch tax is intended to be a substitute for the secondary withholding tax, the five treaties mentioned above do not permit corporations and their shareholders to be lumped together in determining whether discrimination exists.

A similar problem also exists under the language of the nondiscrimination clauses in some of our older treaties. These treaties preclude the additional level of tax on "citizens" of each party to the treaty (including all juridical persons, partnerships, and associations), leaving open the question of whether a branch that is a permanent establishment in one country of a corporation which is a "citizen" of the other country is eligible for relief under the nondiscrimination clause of these older treaties. The policy underlying nondiscrimination clauses would seem to dictate that such clauses be applied to branches. If these treaties are in the category of treaties that do not provide for a branch profits tax, but otherwise permit such tax, the TRA may create the same problem as the original version of the branch profits tax of the House Bill by unilaterally overriding such treaties. If it is clear that such treaties prohibit the branch profits tax, the tax would not override the treaties except in treaty shopping situations. Such clauses exist in treaties with Austria, Denmark, Greece, Ireland, Luxembourg, the Netherlands Antilles, Pakistan, Sweden, Switzerland, and West Germany.

Treaties with Australia, Barbados, Canada, France, New Zealand, Poland, Rumania, South Africa, the U.S.S.R., and Trinidad and Tobago permit the branch level tax, but limit the rate of such tax. These treaties only permit the branch level tax on the profits or taxable income of the branch. To the extent that the branch tax imposes a tax on interest payments attributable to a U.S. branch, it conflicts even with this category of treaties in a treaty shopping situation.

The TRA attempts to resolve the conflict with treaties

[50] TRA §1241(b)(2); Code §861(a)(2)(B), as amended.
[51] §884(e)(3); Conf. Rep. at II-650.
[52] Conf. Rep. at II-650.
[53] §884(e)(3)(B).
[54] Conf. Rep. at II-650.
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] TRA §1241(e).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

by providing that, in the event a particular treaty with a foreign country does not allow the second level branch tax, but does allow the existing second level withholding taxes on dividends, to that extent, the second level withholding tax will continue to apply.[59] Most of the treaties referred to above prevent the second level withholding tax on dividends, in addition to precluding the second level branch tax. In these situations, where both the branch level tax and the withholding tax are made inapplicable by the treaty, if there is treaty shopping, the statute overrides the treaty, and the branch tax will apply.[60] As explained at III, C, *supra*, a foreign corporation is treaty shopping where more than 50% by value of the stock of such corporation is beneficially owned, actually or constructively under §958, by persons who are not residents of the foreign country party to the treaty, or where 50% or more of the foreign corporation's income is used, directly or indirectly, to meet liabilities to persons who are not residents of the foreign country party to the treaty or the United States. In treaty shopping situations, the branch tax overrides any treaty.[61]

The potential for treaty shopping arises, in particular, under the current treaty with the Netherlands Antilles.[62] Under the Netherlands Antilles tax treaty, the second level branch tax could be avoided by conducting the business of a U.S. branch through a corporation organized in the Netherlands Antilles, which has a treaty with the United States that prohibits both the branch tax and the secondary withholding tax. The recently signed treaty with the Netherlands Antilles contains a provision preventing treaty shopping. However, as the treaty is currently signed, the rules preventing treaty shopping will not apply in certain limited circumstances to a corporation that is a Netherlands Antilles resident and which derives income from the ownership of real estate in the United States.[63] Currently, the old Netherlands Antilles tax treaty is in effect and the treaty shopping provisions of the branch tax override that treaty. Should the new treaty be ratified subsequent to the date the current tax bill becomes law, its provisions would override the branch profits tax. The United States and the Netherlands Antilles negotiated the new treaty on the basis of current tax law, however, and, in notes signed at the same time as the treaty, agreed that they would reopen negotiations to assess the impact of the legislation on the treaty and to negotiate any necessary amendments. Therefore, it is possible that the United States may seek renegotiation of the exemption from the treaty shopping rules (and, as a result, from the branch profits tax) that the new treaty gives Netherlands Antilles real estate corporations.

Observation: The 50% local ownership rule, the most integral part of the definition of treaty shopping, may have the unintended effect of taking away a treaty's nondiscrimination protection from enterprises that were intended to benefit from such protection in the past. In fact, many European concerns are owned by residents of more than one country and may fail the 50% test, even if each owner is a resident of a different treaty country that has the same nondiscrimination protection under a bilateral treaty with the United States. Treaty shopping seems unlikely in the last scenario, because most of our treaty partners are higher tax jurisdictions.[64]

B. Technical Problems with the Branch Profits Tax

The statute creates some technical problems. One such important problem is inherent in its use of the concept of "U.S. net equity" to measure the reinvestment or disinvestment of profits in the United States. Insofar as the branch tax base is increased for reductions in net equity and decreased for increases in net equity, taxpayers can manipulate the tax base. However, Congress expects the regulations adopted pursuant to the statutory authority it has given to the Secretary of Treasury to prevent the year-end manipulation of the tax base. Such regulations should also prescribe the necessary adjustments to bring the calculation of the tax base in conformity with the concept of corporate earnings and profits. In this regard, the regulations would have to make adjustments in computing "U.S. net equity" to reflect the rules of §312, which deals with adjustments in computing earnings and profits.

Another technical problem with the statute is that an increase in U.S. liabilities without a corresponding increase in U.S. assets would reduce "U.S. net equity" and trigger the branch tax, even though there are no corresponding earnings. In the situation above, the TRA limits the tax base to earnings and profits, thereby decreasing the likelihood that an increase in liabilities without an increase in earnings will trigger the branch tax. Such an anomalous increase in the tax base runs contrary to the well-established tax principle that taxpayers should not incur a tax if they do not receive the funds with which to pay such tax.[65]

Observation: There is no definition of "branch" in §884. Generally, a branch is an integrated trade or business under the Code or a permanent establishment under tax treaties. There are certain circumstances in which a foreign corporation of a treaty country may not have a permanent establishment in the United States, but may be conducting business here nonetheless under the Code. For example, a foreign corporation may be conducting business in the United States through an independent agent and not have a permanent establishment here. It is unclear whether the branch profits tax would apply in such a case where the foreign corporation did not have a permanent establishment in the United States but was still conducting business here. Congress has left this definitional gap in the statute to the regulations that will be promulgated pursuant to the Secretary's authority.

[59] §884(e)(1)(B).
[60] *Id.*; S. Rep. at 405.
[61] §§884(e)(1) and (3).
[62] The United States has negotiated a new treaty with the Netherlands Antilles that both countries signed August 8, 1986, but which has not been ratified by the Senate yet. Consequently, the old treaty is currently still in effect. The new treaty will be renegotiated in part to take into account the TRA.
[63] Article 16(6), United States-Netherlands Tax Treaty in Respect of the Netherlands Antilles, August 8, 1986 (unratified).
[64] Compared with the highest corporate tax rate of 34% in the United States, the highest corporate rates of tax in Australia (46%), Belgium (45%), Canada (46%), Denmark (50%), France (45%), Germany (56%), Italy (36%), Japan (43%), Mexico (42%), the Netherlands (42%), Sweden (52%), and the United Kingdom (35%) are greater.
[65] *See, e.g.*, §§453, 1031, 1033, the corporate reorganization provisions, and many other provisions deferring gain.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Comment: The reports of the Ways and Means Committee and the Senate Finance Committee characterize the branch tax as a tax on the profits of U.S. branches of foreign corporations.[66] The branch becomes liable for the tax when it remits its profits to its foreign home office. The characterization of the branch tax as a tax on profits is only accurate, however, if the branch remits such profits in the taxable year that it earns them. If the profits that the branch realizes are not remitted to its home office until a later year, then the branch tax is not simply an additional tax on profits, but, in actuality, a tax on capital. This result follows because under our system of annual accounting, income of a taxable year becomes capital on the close of such taxable year in which it is earned or accrued.[67] Since the United States generally taxes income rather than capital, the branch tax seems to be a departure from this norm.

[66] H.R. Rep. No. 426, 99th Cong., 1st Sess. 431-35 (1985); S. Rep. at 401-07.

[67] *See, e.g., U.S. v. Foster Lumber Co.*, 429 U.S. 32 (1976); *Old Colony Railroad Co. v. Comr.*, 284 U.S. 552, 557 (1932); *Burnet v. Sanford & Brooks*, 282 U.S. 359, 365 (1931). Under an annual system of accounting, income becomes capital in subsequent years.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 63

THE SCOPE OF SUBPART F RULES BROADENED [ACT §§1221, 1222, 1223, and 1224]

George B. Delta, Esq.
Silverstein and Mullens
Washington, D.C.

I. Pre-TRA 1986 Law

In general, no current U.S. tax is imposed on the foreign income of a foreign corporation, and a U.S. investor in a foreign corporation is taxed only when income is distributed to him. This deferral of tax on the income of a foreign corporation that is U.S. owned does not apply to certain types of passive income. Under Subpart F of the Internal Revenue Code, §§951-964, the U.S. will impose a current tax on such passive income of a U.S. person who owns at least 10% of the total combined voting power of a foreign corporation that is a controlled foreign corporation ("CFC"). Under pre-TRA §957, a corporation is a CFC if such U.S. persons (10% U.S. shareholders) own more than 50% of the combined voting power of all of the stock of such corporation on any day during the taxable year.

Subpart F income generally includes foreign personal holding company (FPHC) income, consisting mostly of several types of passive income under Code §553. FPHC income consists of dividends, interest, royalties, annuities, gains from the sale of stock or securities (excluding the gains of regular dealers in stock or securities), gains from commodities transactions (excluding gains or losses from certain hedging transactions), gains from the sale or other disposition of an interest in an estate or trust and other amounts includible in the income of the foreign corporation by virtue of Subchapter J (§641 and following), amounts received by a corporation under a personal services contract, amounts received by a corporation by a shareholder owning 25% or more in value of its stock for use of its property, and rents.[1] This definition of FPHC income for purposes of Subpart F excludes other types of FPHC Subpart F income that are passive in nature. Subpart F income also includes foreign base company sales income, foreign base company shipping income (excluding shipping income invested in shipping operations), foreign base company services income, foreign base company oil related income and income derived from the insurance of U.S. risks. A CFC's earnings from insuring foreign risks of unrelated persons escape tax under Subpart F. Interest, dividends, and securities gains received by foreign insurance companies from the investment of premiums and reserves are also not subject to tax under Subpart F.

[1] Code §954(c)(1) and §553, prior to the passage of the Tax Reform Act of 1986 ("TRA") P.L. 99-514 (October 22, 1986).

II. Overview

A. Gain From the Sale of Property That Does Not Generate Income

As a general rule, Code §954(c) has been expanded to include several other types of passive income to the definition of FPHC income for purposes of Subpart F. Dividends, interest, rent, royalties, and annuities earned by a CFC continue to be FPHC income.[2] However, rents and royalties which are derived in the active conduct of a trade or business and which are not received from a related person, do not constitute FPHC income.[3]

In addition to the excess of gains over losses from sales and exchanges of stock and securities (which have been treated as Subpart F income historically, subject to some exceptions relating to banks and insurance companies), the TRA provides that the excess of gains over losses from the sale or exchange of certain other passive investment property is also FPHC income. Code §954(c)(1). Passive investment property is property that produces no income, or produces either (1) dividend and interest income (except as excluded from Subpart F under the active business exception for banks and insurance companies), (2) rents and royalties (excluding active rents and royalties from unrelated third parties), or (3) annuity income. There is an exception to Subpart F treatment if the property is inventory or other dealer property.[4]

Gain from the sale of land that is used by the seller in an active trade or business of the seller at the time of the sale is not Subpart F income.[5] On the other hand, gain on the sale of diamonds held for investment purposes prior to their disposition would be FPHC income. The distinction made in Code §954(c)(1)(B) is demonstrated further by the Senate Report, which states that "gain from the disposition of a patent that gave rise to unrelated party, active business royalties would not be treated as FPHC income,

[2] Code §954(c)(1)(A). *See also* Act §1221. All citations are to sections of the Internal Revenue Code, as amended by the TRA, unless otherwise indicated.

[3] Code §954(c)(2)(A).

[4] Code §954(c)(1)(B).

[5] H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-615 (1986), hereinafter cited as "Conf. Rep."

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

while gain from the sale of a patent licensed to a person related to the seller would be so treated." [6]

Code §954(c) also retained the pre-TRA law exception from current taxation for securities gains of regular dealers and extended this exception to the broader category of passive gains described above. Thus, the sale of a painting by an art dealer does not generate FPHC income for purposes of Subpart F, but the gain generated by a company holding a painting as an investment prior to its sale does generate FPHC income for purposes of Subpart F, because the painting did not give rise to income before its disposition.[7]

B. Gains From Commodity Transactions

The excess of gains over losses from commodities transactions, including income from futures and forward contracts, constitutes FPHC income.[8] Just as under pre-TRA law, gains by a producer, processor, merchant or handler of a commodity which arise from *bona fide* hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others are not FPHC income.[9] Moreover, an additional limitation for active business gains or losses of a CFC substantially all of whose business is that of an active producer, processor, merchant, or handler of commodities is also provided.[10] This exception applies only to CFCs that are actively engaged in commodities businesses, not corporations primarily engaged in financial transactions such as the trading of futures.[11] Income from foreign currency transactions is not taken into account in determining the gains from commodity transactions, because income from such transactions is covered under a separate provision discussed in Part II, C below.[12]

In determining whether a company actively engages in the commodities business, regularly taking delivery of physical commodities will generally indicate the existence of such a business, but it will not be conclusive.[13] Other characteristics of companies actively engaged in the commodities business include: engaging in substantial processing activities and incurring substantial expenses with respect to commodities prior to their sale (*e.g.*, refining, concentrating, mixing, crushing, aerating, and milling), engaging in significant activities and incurring substantial expenses relating to the physical movement, handling and storage of commodities, owning and operating facilities used in the activities described above, owning vessels or vehicles for transporting commodities, and producing the commodities sold.[14]

C. Foreign Currency Gains

TRA 1986 adds to the definition of FPHC income for Subpart F the excess of foreign currency gains over losses attributable to a Code §988 transaction.[15] A Code §988 transaction is any one of the three listed below, if the taxpayer is entitled to receive or is required to pay an amount denominated by a currency other than the U.S. dollar (in most instances):

(1) Acquiring or becoming the obligor under a debt instrument.

(2) Accruing or otherwise taking into account any item of expense, gross income, or gross receipts that is to be paid or received at a later date.

(3) Entering into a forward contract, futures contract, option, or similar financial instrument that is not marmarked-to-market (treated as though sold at fair market value).[16]

Foreign currency gains do not constitute FPHC income in the case of a transaction directly related to the business needs of a CFC. Therefore, active foreign currency gains or losses arising from a CFC's business as an active foreign currency dealer are excluded from FPHC income under Subpart F.[17]

D. Income Equivalent to Interest

Any income that is the equivalent of interest will be treated as FPHC income. TRA 1986 does not define what constitutes the equivalent of interest.[18] For this purpose, commitment fees for a loan constitute interest equivalent income.[19] Congress added Code §954(c)(1)(E) to Subpart F, because taxpayers were sheltering passive interest type of income by rearranging the form of the passive investment so that the income generated was not traditional interest income.[20] Passive leasing income is FPHC income as well.[21]

E. Dividends, Interest and Gains of Banks and Insurance Companies

Under pre-TRA law, there was an exclusion for interest, dividends, and gains from the sale of stock or securities received from unrelated persons in the conduct of a banking, financing, or similar business, or derived from the investments made by an insurance company of its unearned premiums or reserves that were ordinary and necessary for the proper conduct of its insurance business.[22] Under TRA 1986, Subpart F income will include all FPHC income of banks and insurance companies. However, FPHC income will not include any interest which is derived in the conduct of a banking business and which is export financing interest pursuant to Code §904(d)(2)(G).[23] Export financing interest is defined under §904(d)(2)(G) to mean any interest derived from financing the sale or other disposition for use or consumption outside the U.S. of any property which is manufactured, produced, grown, or extracted in the U.S. by the taxpayer or a related person, if not more than 50% of

[6] S. Rep. No. 313, 99th Cong., 2d Sess. 366-67 (1986), hereinafter cited as "Sen. Rep."
[7] Sen. Rep. at 367.
[8] Code §954(c)(1)(C).
[9] Code §954(c)(1)(C)(i).
[10] Code §954(c)(1)(C)(ii).
[11] Sen. Rep. at 367.
[12] Code §954(c)(1)(D).
[13] Sen. Rep. at 367.
[14] *Id.* at 367-68.
[15] Code §954(c)(1)(D).
[16] Code §988(c)(1)(B).
[17] Sen. Rep. at 368.
[18] Code §954(c)(1)(E).
[19] Conf. Rep., p. II-615.
[20] *Id.*
[21] *Id.* at p. II-616.
[22] Pre-TRA Code §954(c)(3)(B).
[23] §954(c)(2)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the fair market value of such property is attributable to products imported into the U. S.[24] Thus, if more then 50% of the value of the property is attributable to products imported into the U.S., the exception for export financing is unavailable.

F. Related Person Exceptions

Subpart F income does not include certain dividends, interest, rents and royalties received by a CFC from a related person under Code §954(c). However, the amendments made by TRA 1986 restrict the pre-TRA rule, excluding from Subpart F such types of income received from a related person. The post-TRA related party exclusion allows a CFC to exclude from Subpart F income dividends and interest that it receives from a related person which is (i) created or organized under the laws of the same foreign country under the laws of which the CFC is created or organized, and (ii) which uses a substantial part of its assets in its trade or business in such foreign country.[25] In addition, the CFC may also exclude from Subpart F income rents and royalties that it receives from a related person for the use of, or the privilege of using, property within the country under the laws of which the CFC is created.[26] Under TRA 1986, however, interest, rent, and royalty payments do not qualify for the related person exclusion to the extent that such payments reduce the Subpart F income of the payor.[27] As a result, if the income of the payor corporation is entirely non-Subpart F income, then the related person exclusions of Code §§954(c)(3) will apply as under pre-TRA law. To the extent that the payor corporation has Subpart F income that is reduced by its payments of interest, rent or royalties, then such income will be treated as Subpart F income to the recipient, notwithstanding the general rules of Code §954(c).

Example: A CFC receives $100 of interest from a related party that is excluded from Subpart F income under Code §954(c)(3). The payee corporation also earns foreign base company services income currently taxable to its shareholders under Subpart F. None of the expenses of the payee corporation are allocable to the $100 of interest in determining the payee's net income subject to income tax under Subpart F. The related party payor of the interest, also a CFC, earns $5,000 of gross manufacturing income that is not subject to tax under Subpart F, and $500 of gross portfolio dividend income that is subject to tax under Subpart F. The payor uses the asset method to allocate its $100 of interest expense for purposes of computing its Subpart F income and, under this method, allocates $90 to its gross manufacturing income and $10 to its gross portfolio dividend income. Since $10 is used to reduce the payor's Subpart F income, $10 of the interest income received by payee CFC is Subpart F income to the payee's U.S. shareholders. This look-through rule will operate in the same manner as in this example for rent, royalty or other similar income otherwise excluded from taxation under Subpart F.[28]

G. Insurance Income

Pre-TRA Code §953(a) currently defines insurance income for purposes of Subpart F to include only income received from the insurance of U.S. risks. TRA 1986 expands the definition of insurance income under Subpart F to include income from insuring those risks situated in a country other than that in which the insurer is created or organized. Thus, for purposes of Subpart F, insurance income means any income that is attributable to the issuing or reinsuring of any insurance or annuity contract in connection with property in, liability arising out of activity in, or in connection with the lives or health of residents of, a country other than the country under the laws of which the CFC is created or organized.[29] In addition, Subpart F will apply to income attributable to an insurance contract in connection with risks located in the insurer's country of organization as the result of an arrangement under which another corporation receives a substantially equal amount of premiums or other consideration for insuring risks outside the insurer's country of organization.[30] The amount of income that is subject to tax as Subpart F insurance income is the amount that would be taxed under Subchapter L of the Code, if it were the income of a domestic insurance corporation (subject to the modification Code §953(b)).[31] Thus, Code §953(a) subjects to U.S. taxation the investment income of an insurance company, as well as its premium income. TRA 1986 repealed the *de minimis* rule of pre-TRA Code §953(a)(1), which excluded income from the insurance of U.S. risks that would otherwise have been subject to Subpart F, if such income constituted 5% or less of the total premium type of income of an insurance company. Thus, any income of a CFC from the insurance of risks located in other countries will be subject to current taxation under Subpart F in accordance with Subchapter L (as modified). However, the modified Subpart F *de minimis* rule of Code §954(b)(3) (discussed in greater detail in Part II, Q below) has been extended to apply to insurance income.

H. Captive Insurance Company Income

TRA 1986 also includes a special provision for captive insurance companies. Generally, a captive insurance company is one organized by one or more persons primarily to provide insurance protection to its owners or persons related to its owners. Offshore captives provide significant tax benefits if the premiums are deductible as *bona fide* insurance premiums, because generally no current tax is imposed on the premium income in the hands of the captive. In many instances, courts have found that there was no shifting of risk in the captive insurance company situation and have denied the parent a deduction for the amount paid as a premium to its captive.[32] However, under Rev. Rul. 78-338, 1978-2 C.B. 107, U.S. persons were able to secure a deduction for premiums paid to a captive and escape current U.S. tax by spreading out the ownership of the

[24] §904 (d)(2)(G).
[25] Code §954(c)(3)(A)(i).
[26] Code §954(c)(3)(A)(ii). See Paragraph II, K below for the definition of related person.
[27] Code §954(c)(3)(B).
[28] Sen. Rep. at 369-70.
[29] Code §953(a)(1)(A); see also Act §1221.
[30] Code §953(a)(1)(B).
[31] Code §953(a)(2).
[32] *See, e.g., Stearns-Roger Corp. v. U.S.*, 774 F.2d 414 (10th Cir. 1985); *Carnation Co. v. U.S.*, 640 F.2d 1010 (9th Cir. 1981); *Clougherty Packing Co. v. Comr.*, 84 T. C. 948 (1985); *Mobil Oil Corp. v. U.S.*, 8 Cl. Ct. 555 (1985); *see also* Rev. Rul. 77-316, 1977-2 C.B. 53.

captive insurer among several persons. The purpose of post-TRA Code §953(c) is to subject the related person insurance income of offshore captive insurance companies that previously avoided tax because of a relatively widespread dispersal of U.S. ownership to current U.S. tax.

Insurance income that is related person insurance income will be taxable currently to an expanded category of U.S. persons. Related person insurance income is any insurance income that is attributable to a policy of insurance or reinsurance with respect to which the primary insured is a U.S. shareholder in the foreign corporation or a related person (within the meaning of §954(d)(3)) to such U.S. shareholder.[33] A U.S. shareholder, with respect to a foreign corporation, is any shareholder who is a U.S. person who owns, actually or constructively, under Code §958(a), any stock of the CFC.[34] For purposes of taking into account this related person insurance income, the U.S. ownership threshold for CFC status is ownership of 25% or more of the combined voting power of all of the corporation's stock or 25% or more of the total value of such stock (not 50% or more).[35] The definition of insurance income for captive insurance companies is the same as under Code §953(a), therefore, the investment income of a captive insurance company, as well as its premium income are subject to current taxation. Premium income also includes income attributable to officers' or directors' insurance if the U.S. shareholders of the CFC receiving such income (or persons related to such shareholders) pay the premiums directly or indirectly, and the insureds are officers or directors of the U.S. shareholders (or persons related to such U.S. shareholders).[36]

There are three exceptions to the current taxation of related person insurance company income. First, such income is not currently taxable if the CFC's gross related person insurance income for the year is less than 20% of all of its gross insurance income for the year.[37] The definition of insurance income is the same as under Code §953(a)(1), except that the exclusion of income attributable to the insurance of same-country risks is inapplicable.[38] The purpose of this exception is to exclude from the operation of Code §953(c), foreign insurance companies with 25% or more U.S. ownership that do not earn a significant proportion of related person insurance income.[39]

Second, related person insurance income of a CFC will not be currently taxable if less than 20% of the total combined voting power of all the classes of stock entitled to vote and less than 20% of the total value (stock and policies) of such corporation during the taxable year are owned (directly and indirectly) by persons who are the primary insureds under any policy of insurance or reinsurance or by persons who are related to such primary insureds.[40]

Third, related person insurance income will not be currently taxed as Subpart F income if the CFC elects to treat it as income effectively connected with the conduct of a U.S. trade or business taxable under Code §882.[41] While this election generally subjects the related person insurance income to current taxation, it also allows the CFC to receive the same tax benefits that similarly situated U.S. insurers enjoy with respect to related person insurance income. Thus, for example, an electing offshore captive insurer that incurs net operating losses from meeting large claims may carry such losses back three years and forward 15 years under Code §172.[42] The availability of loss carryovers provides a great benefit to insurers of those risks with respect to which the Code does not permit deductions for reserves. The election under §953(c)(3)(C) is to be made at such time and such manner as the Secretary of Treasury prescribes and will be effective in the year made and all subsequent years. The election is revocable only with the Secretary's consent.[43] In order for the election to be effective, the CFC must waive all benefits available under an income tax treaty with respect to related person insurance income. The election is only effective if the electing CFC meets such requirements as the Secretary prescribes to ensure that the tax on related person insurance is collected.[44]

Post-TRA Subpart F rules for offshore captive insurance companies apply to mutual insurance companies as well as stock insurance companies with the policyholders treated as the stockholders.[45] The Secretary is empowered to promulgate regulations to adapt the application of this rule providing for current taxation of related person insurance income to mutual insurance companies.

Comment: Foreign mutual insurance companies insuring a substantial number of U.S. persons will have significant amounts of related person insurance income, solely because a mutual insurance company is owned by its policyholders. As long as such income is effectively connected with the conduct of a U.S. trade or business, it is taxed by the U.S. as if the policyholders have permanent establishments in the U.S.[46] As such, the related person insurance income is taxed outside of the Subpart F rules, and the revised definition of related person insurance income under §953(c) will have no impact on foreign mutual insurance companies.

The Secretary has been given broad authority to promulgate regulations under Code §953(c), including regulations preventing the avoidance of the revised rules of Code §953(c) through cross-insurance agreements.[47]

Example: A foreign insurance company is owned by 35 unrelated U.S. persons who are engaged in similar businesses. In profitable years, the company will have related person insurance income that is currently taxable as Subpart F income under Code §953(c).[48] Assume that instead

[33] Code §953(c)(2).
[34] Code §953(c)(1)(A).
[35] Code §953(c)(1)(B).
[36] Conf. Rep., p. II-618-19.
[37] Code §953(c)(3)(B).
[38] *Id.*
[39] Conf. Rep., p. II-619.
[40] Code §953(c)(3)(A).
[41] Code §953(c)(3)(C).
[42] Conf. Rep., p. II-619.
[43] Code §953(c)(3)(D)(i).
[44] Code §953(c)(3)(C)(ii).
[45] Code §953(c)(4).
[46] *See* Code §882.
[47] Code §953(c)(5).
[48] *See* Code §951.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

of one CFC, two CFCs, one owned by 18 U.S. persons, the other by the remaining 17 U.S. persons, are formed. The primary business of the first CFC is to insure the risks of the owners of the second CFC; the primary business of the second CFC is to insure the risks of the owners of the first CFC. The Conference Report states that this cross-insurance arrangement is the same as the standard captive insurance arrangement, and that the income of both CFC's will be taxed under Subpart F as related person insurance income.[49]

I. Foreign Base Company Shipping Income

Under pre-TRA law Code §954(b)(2), foreign base company shipping income is excluded from Subpart F income to the extent that the amount of foreign base company shipping income is reinvested in foreign base company shipping operations.[50] Act §1221(c) of TRA 1986 repeals §954(b)(2) and (g), therefore, any income that constitutes foreign base company shipping income is taxable as Subpart F income, regardless of the CFC's use of the income. In addition, Code §954(f), defining foreign base company shipping income, is broadened to include any income derived in space, on the oceans, or Antarctica.[51]

J. Foreign Corporation Not Used to Reduce Taxes

Under pre-TRA law Code §954(b)(4), foreign base company income does not include any income received by a CFC if the creation of such CFC and the transaction giving rise to such income did not have as a "significant purpose" the substantial reduction or avoidance of tax. Code §954(b)(4) does not apply to foreign base company oil related income. This subjective tax avoidance test is replaced with an objective test. Under the post-TRA test, Subpart F income will not include items of foreign base company income received by a CFC, if the CFC establishes, to the satisfaction of the IRS, that the income was subject to an effective rate of income tax imposed by a foreign country that is at least 90% of the maximum U.S. corporate tax rate under Code §11.[52] Code §954(b)(4) still does not apply to foreign base company oil related income.[53]

Although the revised rule applies separately to every item of income received by a CFC, the IRS is expected to promulgate regulations grouping items of income that bear substantially equal effective tax rates in a given country.[54] For example, all interest income of a CFC from sources in its country of incorporation may be treated as one item of income.[55]

Comment: The reason for the change is to make the rule of Code §954(b)(4) more certain. Because moveable income could be earned through a U.S. corporation as easily as through a CFC, a U.S. taxpayer may use a CFC to earn such income if it can obtain significant tax savings. If no significant tax savings exist in routing income through a CFC, however, there is little reason to impose a tax under Subpart F. Since most countries have higher corporate tax rates than the U.S., amended §954(b)(4) is aimed at corporations receiving income from tax haven countries.

K. Definition of Related Person

Under pre-TRA Code §954(d)(3), a related person is defined as an individual, partnership, trust or estate which controls the CFC, a corporation which controls or is controlled by the CFC, or a corporation which is controlled by the same persons that control the CFC. A partnership, trust, or estate in which the CFC holds an interest is not a related person. Control of a corporation is defined as direct or indirect ownership of stock possessing more than 50% of the total combined voting power of all of the classes of stock entitled to vote.

TRA 1986 expands the definition of a related person in Code §954(d)(3).[56] A partnership, trust or estate that controls or is controlled by a CFC, as well as a partnership, trust or estate which is controlled by the same persons controlling the CFC are related persons.[57] Control of a corporation is expanded to include direct or indirect ownership of 50% or more of the voting power of all classes of stock entitled to vote, or direct or indirect ownership of 50% or more of the total value of stock of such CFC.[58] In the case of a partnership, trust or estate, control is direct or indirect ownership of 50% or more of the total value of the beneficial interests in such entity.

L. Repeal of the Chain Deficit Rule and Modification of the Accumulated Deficit Rule

The "chain deficit rule" of pre-TRA Code §952(d), under which a CFC could reduce its earnings and profits by a deficit in the earnings and profits of a commonly owned CFC in the same chain of ownership, has been repealed.[59] TRA 1986 also limits the present law rule known as the accumulated deficit rule, permitting a CFC to reduce its Subpart F income (as defined §952(a)) by the sum of its prior year deficits in earnings and profits.[60]

The Conference Report, provides several reasons for restricting the use of deficits to reduce Subpart F income. First, Congress has sought to simplify the operation of the separate limitation look-through rules for CFCs by conforming them and the Subpart F rules more closely. Secondly, the present law deficit rules allow U.S. taxpayers operating abroad through CFCs to shelter too much income earned in tax haven countries from current U.S. tax. Under the chain deficit rule of Code §952(d), a loss incurred anywhere in a chain of CFCs eliminates U.S. tax on an equal amount of income earned elsewhere in the chain even though the loss may be in a non-Subpart F income category, or bear little or no relation to the income that it offsets. Similarly, the accumulated deficit rule of pre-TRA §952(c) allows a CFC to avoid tax on Subpart F income by offsetting that income with prior year deficits incurred in non-Subpart F or unrelated income categories. Were this rule not modified, in many cases, taxpayers could shelter

[49] Conf. Rep, p. II-620-21.
[50] *See also* pre-TRA Code §954(g), repealed.
[51] Act §1221(c)(2), amending Code §954(f).
[52] Code §954(b)(4).
[53] *Id.*
[54] H.R. Rep. No. 426, 99th Cong., 1st Sess. 400 (1985).
[55] *Id.* at 400-01.
[56] TRA §1221(e).
[57] Code §954(d)(3).
[58] *Id.*
[59] TRA §1221(f).
[60] Code §§952(c)(1) and (2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

from U.S. tax, income from passive investment simply by moving those investments into CFCs with prior year deficits.[61]

Observation: Deficits in earnings and profits incurred by foreign corporations before their acquisition by a U.S. corporation may be used to shelter post-acquisition Subpart F income of the U.S. corporation from tax under pre-TRA law, unless the IRS can show under Code §269 that the acquisition was made to evade or avoid income tax. Selling the losses of a CFC is not restricted by any rule corresponding to the special rule that limits the carryover of losses found in Code §382 that is applicable to U.S. corporations. The TRA's repeal of the chain deficit rule and its modifications to the accumulated deficit rule limit the use of acquired deficits.

Another problem that led to the repeal of the chain deficit rule is the ability that the provision confers upon certain taxpayers to effectively utilize the same deficits twice. Assume, for example, that a U.S. corporation controls two foreign corporations. One of these CFCs owns the other CFC. One of the CFCs, the loss corporation, has a current deficit in earnings and profits of $100. To fund that deficit the U.S. corporation makes an additional $100 contribution to the loss corporation's capital. That capital contribution increases by $100 the U.S. corporation's basis in its stock and in the loss corporation. Under the chain deficit rule, the $100 deficit reduces the second CFC's currently taxable Subpart F income in the year in which the deficit arises. In the following year, the U.S. corporation's stock in the loss corporation becomes worthless. Under the rules governing the deduction of losses for worthless securities, Code§165(g), that stock is a capital asset and the U.S. corporation may therefore deduct in full its basis in the stock, including the $100 component of that basis corresponding to the prior year's additional capital contribution. Therefore, the loss corporation's $100 deficit in earnings and profits reduces the U.S. corporation's taxable income twice, once in the first year under the chain deficit rule, and then again in the following year under the rule allowing a loss deduction for worthless securities. A similar result may be achieved when debt is used to fund a CFC's loss and is later written off.[62]

As a general rule, post-TRA §952(c) provides that foreign base company shipping income, foreign base company oil related income, Subpart F insurance income, or FPHC income may be reduced only by accumulated deficits in earnings and profits which are attributable to activities that give rise to foreign base company shipping income, foreign base oil related income, Subpart F insurance income, or FPHC income, respectively.[63] Other categories of Subpart F income may not be reduced by accumulated deficits under post-TRA Code §952(c).[64] Under the rule in post-TRA Code §952(c), Subpart F insurance income may be reduced by an accumulated deficit from insurance activities only if the CFC receiving such income was predominantly engaged in the active conduct of an insurance business (within the meaning of post-TRA Code §904(d)(2)(C)(ii)), in both the year in which the income was earned and the year in which the deficit arose.[65] FPHC income may be reduced under the post-TRA accumulated deficit rule only if the CFC receiving such income was predominantly engaged in the active conduct of a banking, financing, or similar business, within the meaning of post-TRA §904(d)(2)(C)(ii), in both the year in which the income was earned and the year in which the deficit arose.[66] Accumulated deficits may only be used once.[67] In order to be eligible for use under the rule, an accumulated deficit must arise in a year for which the foreign corporation incurring such deficit is a CFC.[68] As under pre-TRA law, accumulated deficits that cannot be used in one year may be carried over indefinitely for possible use in later years. Under the accumulated deficit rule, as modified, accumulated deficits for taxable years beginning before 1987 may not be carried forward to reduce Subpart F income.[69]

A U.S. shareholder in a CFC may reduce its Subpart F inclusion with respect to that CFC only by the shareholder's *pro rata* share of accumulated deficits.[70] A U.S. shareholder's *pro rata* share of any accumulated deficit is to be determined under rules that are similar to the rules which limit Subpart F inclusions to a shareholders *pro rata* share of Subpart F income under §951(a)(2), for whichever of the following yields the smaller share: (i) the close of the current taxable year or (ii) the close of the year in which the deficit arose.[71] Under this rule, the use of accumulated deficits will be limited by the size of the U.S. shareholder's interest in a CFC in the current year and in the year in which the deficit was incurred. Under pre-TRA law, Subpart F and §1248 inclusions are similarly limited by the size of a shareholder's interest in the CFC when the relevant earnings and profits arose.[72]

Under post-TRA §952(c), pre-acquisition deficits of an acquired corporation to which a CFC in the acquiring group succeeds will not reduce its post-acquisition Subpart F income of a CFC's shareholders, except to the extent that such shareholders had ownership interests in the acquired corporation when the deficits arose.[73] Similarly, pre-merger deficits of a foreign corporation merged into a CFC will not reduce post-merger Subpart F income of the CFC's shareholders, except to the extent that such shareholders had ownership interests in the merged corporation when the deficits arose.[74] The Conference Report states that the Secretary of the Treasury is to promulgate regulations implementing the above rules, including regulations that limit the use of deficits in connection with other reorganizations.

The pre-TRA rule that permits current deficits in earnings and profits in any income category including

[61] Conf. Rep., p. II-623.
[62] Conf. Rep., p. II-624.
[63] §952(c)(1)(B)(ii)(I).
[64] Conf. Rep., p. II-621.
[65] §§952(c)(1)(B)(iii)(III) and (v).
[66] §952(c)(1)(B)(iii)(IV) and (vi).
[67] §952(c)(1)(B)(ii)(II).
[68] §952(c)(1)(B)(ii).
[69] §952(c)(1)(B)(ii); Conf. Rep., p. II-622.
[70] §952(c)(1)(B)(i).
[71] §952(c)(1)(B)(iv).
[72] Conf. Rep., p. II-622.
[73] §952(c)(1)(B)(iv); Conf. Rep., p. II-622.
[74] *Id.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

non-Subpart F income categories, to reduce Subpart F income for the taxable year is retained.[75] However, if Subpart F income of a CFC is reduced by reason of §952(c)(1)(A) any excess of the earnings and profits of that corporation over its Subpart F income in any subsequent taxable year will be recharacterized as Subpart F income under rules similar to the separate limitation loss recharacterization rule of Code §904(f)(5), and thus, will be currently included in the income of the CFC's U.S. shareholders in such year of recharacterization.[76] Under this recharacterization provision, Subpart F-type income that is recaptured for foreign tax credit limitation purposes under the separate limitation loss recharacterization rule is effectively recaptured for Subpart F purposes as well.[77] For example, income of a CFC that is passive after application of the separate limitation loss recharacterization provision is also FPHC income currently taxable to the CFC's U.S. shareholders under Subpart F. The Subpart F recharacterization provision thus helps to integrate Subpart F and the separate foreign tax credit limitation rules.[78] The operation of the foregoing rules is demonstrated by the following four examples.

Example (1): The application of the accumulated deficit rule may be demonstrated as follows. Assume that a CFC, wholly owned by a U.S. corporation, incurs a $100 deficit in earnings and profits in a taxable year. Also assume, that gross income, net taxable income, and earnings and profits are the same. Sixty dollars of the deficit is attributable to activities that, when profitable, generate foreign base company shipping income. The other $40 of the deficit is attributable to activities that, when profitable, generate foreign base company oil related income. In the following year, the CFC earns $90 of foreign base company shipping income, $20 of foreign oil related income, and $10 foreign base company services income. The full $60 portion of the accumulated deficit attributable to base company shipping activity can be used to reduce the U.S. parent's base company shipping income inclusion with respect to the foreign corporation. Thus, the foreign base company shipping income is reduced to $30. Twenty dollars of the $40 portion of the accumulated deficit attributable to base company oil related activity can be used to eliminate the $20 of base company oil related income. The remaining $20 of accumulated deficit cannot be used to reduce the U.S. parent's base company services income or remaining base company shipping income since this deficit amount did not arise from base company services or shipping activity. For the year, therefore, the U.S. parent's Subpart F income with respect to the foreign corporation after the accumulated deficit is applied consists of $30 of base company shipping income, $10 of base company services income and no base company oil related income. The $20 portion of the accumulated deficit attributable to foreign oil related activity which is not used may be carried over for possible use in characterizing distributions from the foreign corporation in later years.[79]

Example (2): Assume, that a foreign manufacturer, wholly owned by a U.S. corporation, incurs a $100 deficit in earnings and profits in a taxable year. The manufacturing operations of a CFC, when profitable, generate non-Subpart F income. In the following year, the U.S. parent sells through the foreign manufacturer to third country buyers goods that a U.S. subsidiary of the U.S. parent produces. With respect to these sales, the foreign corporation receives $30 of foreign base company sales income, currently taxable to its U.S. parent under Subpart F. The foreign corporation also earns $80 of non-Subpart F manufacturing income. The amendment to the accumulated deficit rule limits to $80 the amount of the $100 accumulated deficit which may be used in this year. Since the accumulated deficit arose in a non-Subpart F income category, it may offset only the $80 of non-Subpart F income. For the year, therefore, the Subpart F income after the accumulated deficit is applied consists of $30 of foreign base company sales income. The $20 portion of the accumulated deficit not used may be carried over by the foreign corporation to reduce non-Subpart F earnings and profits in later years.[80]

Example (3): Assume that a foreign corporation, wholly owned by a U.S. corporation, incurs a $100 deficit in earnings and profits in a taxable year. The CFC is predominately engaged in the active conduct of a banking business during that year. When profitable, the CFC earns primarily FPHC income, as that category of Subpart F income is expanded by the statute. The deficit arises from activities that generate FPHC income. On the first day of the following year, 40% of the stock of the CFC is sold to a second U.S. corporation. The CFC earns $300 of FPHC income and no other income during that taxable year. It is predominantly engaged in the active conduct of a banking business during that year. The second U.S. corporation's share of the Subpart F income is $120, 40% of $300. The second U.S. corporation cannot reduce its Subpart F inclusion by any portion of the $100 accumulated deficit, because it owned no stock in the CFC in the preceding year, when the deficit was incurred. The first U.S. corporation can reduce its $180 (60% of $300) share of the Subpart F income by $60 (60% of $100) of the accumulated deficit; under the accumulated deficit rule, as modified, its *pro rata* share of the deficit is determined for the close of the current year because such determination yields a smaller *pro rata* share than a determination of such share for the close of the deficit year. The $40 portion of the accumulated deficit not utilized may be carried over for possible use by the first U.S. corporation in later years.[81]

Example (4): The interaction of the new Subpart F recharacterization rule, the Subpart F earnings and profits limitation, and the foreign loss allocation and separate limitation loss recharacterization is illustrated as follows.[82] Assume a CFC wholly owned by a U.S. corporation has a $100 overall limitation loss, and $200 of FPHC (passive) income under Subpart F before allocation of the loss. Earnings and profits equal income. Under the foreign loss allocation rule (which mirrors the earnings and profits

[75] §952(c)(1)(A).
[76] §952(c)(2); Conf. Rep., p. II-622.
[77] *Id.*
[78] Conf. Rep., p. II-622-23.
[79] *Id.* at p. II-624-25.
[80] *Id.* at p. II-625.
[81] *Id.* at p. II-625-26.
[82] *Id.* at p. II-626.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

limitation under Subpart F), the $100 loss reduces the CFC's passive income for the year to $100. The Subpart F earnings and profits limitation reduces the income currently taxable to the CFC's U.S. shareholders correspondingly to $100. The following year, the CFC earns $250 of FPHC (passive) income under Subpart F and $1,500 of overall limitation (*i.e.*, non-Subpart F) income. Under the separate limitation loss recharacterization rule, an amount of this overall limitation income equal to the prior year's overall limitation loss that reduced FPHC passive income, $100, is recharacterized as passive income. As a result, for foreign tax credit limitation purposes, the CFC has $1,400 ($1,500 - $100) of overall limitation income and $350 ($250 + $100) of passive income in the second year. The Subpart F recharacterization rule provides that the recaptured $100 of passive income is also FPHC income for purposes of Subpart F, because Subpart F FPHC income the year before was reduced by $100 under the earnings and profits limitation and, in the current year, earnings and profits exceed tentative Subpart F income by at least that amount. Therefore, the Subpart F inclusion of the CFC's shareholders is $350 in the second year.[83]

M. Effective Date — TRA 1986 §1221

The provisions discussed in II, A-L, *supra*, all amended by TRA 1986 §1221, are generally effective for taxable years of foreign corporations beginning after December 31, 1986. The effective date for the repeal of the exclusion for reinvested shipping income, however, is for taxable years ending on or after January 1, 1992. In addition, in the case of the first three taxable years of a qualified controlled foreign insurer beginning after December 31, 1986, the amendments made by §1221 do not apply to the phase-in percentage of any qualified reinsurance income.[84]

N. New Definition of Controlled Foreign Corporations [TRA 1986 §1222(a)]

A corporation is a CFC, under pre-TRA law, only if more than 50% of the total combined voting power of the corporation is owned by U.S. shareholders that each own at least 10% of that voting power.[85] Under this definition of a CFC, taxpayers could structure their investments to avoid Subpart F by ensuring that they did not own more than 50% of the voting power of a corporation, even if they owned the majority of its value in nonvoting stock. TRA 1986 changed the definition to provide that a corporation is a CFC if more than 50% of the total combined voting power of all classes of stock of such corporation entitled to vote, or the total value of the stock of such corporation, is owned (directly or indirectly under Code §958(a)) by U.S. shareholders on any day during the taxable year.[86] The definition of a U.S. shareholder continues to be any U.S. person who owns (directly or indirectly under Code §958(a)) 10% or more of the total combined voting power of all classes of stock entitled to vote.[87] A corresponding amendment was made to Code §957(b) (relating to the definition of a CFC for purposes of taking into account insurance income under Code §953(a)), which defined a CFC as a corporation of which more than 25% of the voting power or value is owned by U.S. shareholders on any day during the taxable year, if the gross amount of premiums or other consideration described in TRA 1986 Code §953(a)(1) exceeds 75% of the gross amount of all premiums or other consideration in respect to all risks.[88]

O. Definition of Foreign Personal Holding Company [TRA §1222(b)]

Under pre-TRA law, a corporation is a FPHC, only if more than 50% of the value of such corporation is owned by five or fewer U.S. individuals.[89] This provision was expanded so that a corporation is a FPHC if more than 50% of the value of its stock, or the total combined voting power of all classes of stock entitled to vote, is owned (directly or indirectly) by five or fewer U.S. individuals.[90]

P. Effective Dates — TRA §1222(c)

The amendments to the definitions of CFCs and FPHCs are effective for taxable years beginning in 1987. However, for purposes of applying Code §§951(a)(1)(B) and 956, the definition of a CFC takes effect on August 16, 1986.[91] Property acquired by the CFC before August 16, 1986 need not be taken into account under Code §956(b).[92]

Q. Subpart F De Minimis Rule [TRA §1223]

The Subpart F *de minimis* rule now extends to insurance income as well. Thus, gross income of a CFC that is foreign base company income under Code §954(a) or insurance income under Code §953(a) is excluded from Subpart F income under Code §954(b)(3), if the sum of foreign base company income and gross insurance income is less than the lesser of (i) 5% of gross income, or (ii) $1,000,000.[93] Previously, the *de minimis* rule exempted foreign base company income if it was less than 10% of gross income, and a separate *de minimis* rule applied to insurance income which excluded such income from Subpart F if the premiums or other consideration received in connection with the insurance of U.S. risks did not exceed 5% of all premiums or other consideration in respect to insurance of all risks.[94] Code §954(b)(3)(B) provides that if the sum of foreign base company income and gross insurance income for the taxable year exceeds 70% of gross income, then the entire gross income constitutes Subpart F income. Previously, this 70% full inclusion rule did not include insurance income.[95] The TRA 1986 Subpart F *de minimis* rule applies for foreign tax credit limitation purposes as well.[96]

R. Effective Date — TRA §1223(c)

The amendments to the Subpart F *de minimis* rule and the full inclusion rule apply to taxable years beginning after December 31, 1986.

[83] *Id.* at p. II-626.
[84] TRA §1221(g).
[85] Pre-TRA Code §§957(a) and 951(b).
[86] Code §§957(a)(1) and (2).
[87] Code §951(b).
[88] Code §957(b). Cross reference to paragraph II, G above.
[89] Pre-TRA Code §552(a)(2).
[90] Code §552(a)(2)(A) and (B).
[91] TRA §1222(c)(1).
[92] TRA §1222(c)(2).
[93] Code §954(b)(3)(A).
[94] Pre-TRA Code §§954(b)(3)(A) and 953(a).
[95] Pre-TRA Code §954(b)(3)(B).
[96] Conf. Rep., p. II-627. See paragraphs II, G and H for a general discussion of insurance income and captive insurance income.

S. Repeal of Special Treatment for Possessions Corporations [TRA §1224]

Corporations chartered in U.S. possessions or Puerto Rico were not treated as CFCs if at least 80% of such corporation's gross income for the three year period immediately preceding the close of the taxable year was derived from sources within a U.S. possession or Puerto Rico, and at least 50% of such corporation's income during such period was derived from the active conduct of a trade or business constituting fishing, the manufacture or processing of certain goods, the processing of agricultural or horticultural products, or the ownership of hotels in a U.S. possession or Puerto Rico.[97] Therefore, U.S. shareholders of possessions corporations that were previously exempt from tax because such corporations were not CFCs under the special rule, now face U.S. taxation of the current earnings and profits of these corporations.

[97] Pre-TRA Code §957(c), repealed by TRA §1224(a).

T. Effective Dates — TRA §1224(b)

The repeal of Code §957(c) is effective for taxable years of foreign corporations beginning after December 31, 1986.[98] However, for purposes of applying Code §§951(a)(1)(B) and 956, the repeal takes effect on August 16, 1986.[99] Property acquired by the possessions corporations before August 16, 1986 need not be taken into account under Code §956(b).[100]

[98] TRA §1224(b)(1).
[99] *Id.*
[100] TRA §1224(b)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 64

NEW RULES GOVERNING THE TREATMENT OF CERTAIN PASSIVE FOREIGN INVESTMENT COMPANIES [ACT §1235]

Deborah M. Beers, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

Prior to the passage of the Tax Reform Act of 1986, [1] the foreign source income of a foreign corporation generally was not subject to U.S. taxation unless, by reason of the control of the foreign corporation by U.S. persons, the corporation met the definition either of a controlled foreign corporation, a foreign personal holding company or a foreign investment company.[2] A foreign corporation meeting the definition of one of the foregoing types of entities is subject to tax on a current basis, at the shareholder level, on all or a part of the foreign corporation's earnings and profits. Each entity has different requirements related to its ownership and income, some of which overlap.

A. Foreign Personal Holding Companies

The foreign personal holding company (FPHC) provisions [3] have been part of the Internal Revenue Code since 1937 when they were enacted as a complement to the personal holding company (PHC) legislation of 1934 to prevent the abuse known as the foreign "incorporated pocketbook", whereby United States shareholders would accumulate in foreign corporations certain types of passive income without incurring any U.S. tax liability. Since the United States has no jurisdiction over a foreign corporation which does not have any U.S. source income, the FPHC rules require "United States shareholders" of the foreign corporation to include in gross income their proportionate share of the corporation's "undistributed foreign personal holding company income" (UFPHCI). "United States shareholders" [4] may include U.S. citizens or residents, U.S. corporations, U.S. partnerships, or estates and trusts (other than those estates and trusts whose gross income includes only income from sources within the United States) without regard to percentage of ownership.

For purposes of determining which corporations meet the definition of FPHC, Code §552 sets forth both a "gross income requirement" and a "stock ownership requirement." Under the gross income test, at least 50% (60% initially) of the gross income of a foreign corporation for the taxable year must be foreign personal holding company income (generally passive types of income including interest, dividends, rents and royalties). For taxable years beginning prior to January 1, 1987, the stock ownership test requires that at any time during the taxable year more than 50% in value of the outstanding stock of a foreign corporation must be owned directly or indirectly by or for not more than five individuals who are citizens or residents of the United States (the "United States group").[5] For taxable years beginning after December 31, 1986, ownership of more than 50% in value *or* voting power will satisfy the stock ownership requirement.[6] For purposes of determining the ownership of stock, the attribution rules of Code §554 apply.

B. Controlled Foreign Corporations

1. Current Inclusion of E&P in Income of U.S. Shareholders

Subpart F (Code §§951-964) was added to the Internal Revenue Code in 1962. [7] The avowed purpose of the Subpart F provisions was to prevent the use of "tax havens" to reduce or eliminate tax liabilities of United States persons both at home and abroad.[8] Under Subpart F, a United States person who owns, or is considered to own, 10% or more of the total combined voting power of all classes of stock entitled to vote of a "controlled foreign corporation" (CFC)[9] is required to include in gross income his *pro rata* share of certain types of income of the CFC. In general, the includible income consists of: (1) the *pro rata* share of the CFC's "Subpart F income" (including foreign personal holding company income) for the year; (2) the *pro rata* share of the CFC's previously excluded "Subpart F income" withdrawn from investments in less developed countries; (3) the *pro rata* share of the CFC's previously excluded "Subpart F income" withdrawn from foreign base company shipping operations for such year; and (4) the *pro*

[1] P.L. 99-514, 99th Cong., 2d Sess., (1986) (hereinafter sometimes "TRA").

[2] *See generally* §§551 *et seq.* (foreign personal holding companies); 941 *et seq.* (controlled foreign corporations); and 1246 and 1247 (foreign investment companies).

[3] For a detailed discussion of the FPHC provisions *see* Lerner and Kirschbaum, 103 T.M., *Foreign Personal Holding Companies.*

[4] Code §551(a).

[5] Code §552(a)(2).

[6] TRA §1222(b).

[7] P.L. 87-834, 87th Cong., 2d Sess., Oct. 16, 1962.

[8] *See, e.g.*, H. Rep. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 461.

[9] A more detailed description of the definitional provisions applicable to CFCs appears in Mulroney, 432 T.M., *Subpart F - Background, Basic Concepts and Terminology.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

rata share of the CFC's increase in earnings invested in U.S. property.[10]

As defined in §957 of the Code, a CFC is any foreign corporation of which, for taxable years beginning prior to January 1, 1987, more than 50% of the total combined voting power of all classes of stock entitled to vote is owned, actually or constructively, by "United States shareholders" on any day during the taxable year of such foreign corporation. As with FPHCs, the stock ownership test is modified for years beginning after December 31, 1986, to include ownership of more than 50% in voting power *or* value of a foreign corporation.[11] The term "United States shareholder" is defined under Code §951(b) as those United States persons actually or constructively owning 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.[12] For purposes of determining constructive ownership of stock in a CFC, attribution rules are contained in §958 of the Code. These rules closely mirror the attribution provisions of §318 of the Code, except that stock owned by non-resident alien individuals may not be attributed to a U.S. person.[13]

As a result of the foregoing ownership requirements, if 11 unrelated U.S. persons each own more than 9%, but less than 10%, of the voting power or value of a foreign corporation, that corporation will not be a CFC (although it may be an FPHC). In addition, if four U.S. persons each own 11% of the voting power of a foreign corporation and non-U.S. persons own the rest, the U.S. persons will be U.S. shareholders but the foreign corporation will not be a CFC because the total voting power owned by U.S. persons is less than 50%.

2. *Ordinary Income Treatment of Gain on Sale or Exchange of CFC Stock*

In addition to current inclusion in income of U.S. shareholders of a controlled foreign corporation, a portion of the gain on the sale or exchange (including deemed exchanges under §§302 and 331) of CFC stock recognized by a 10% or more U.S. shareholder may be treated as ordinary dividend income (eligible for the deemed paid foreign tax credit) under §1248 of the Code.[14] The portion treated as ordinary income is equal, with adjustments, to the post-1962 earnings and profits of the CFC accumulated during the period of ownership of the U.S. shareholders. Section 1248 generally does not apply to U.S. shareholders owning stock in a foreign corporation which has not been a CFC within five years preceding the sale date.[15] It is thus theoretically possible for shareholders of the CFC to obtain long-term capital gains treatment on appreciation of the CFC stock by arranging to decontrol the CFC at least five years prior to the sale date of the stock.

C. *Foreign Investment Companies*

The provisions relating to foreign investment companies (FICs) [16] were added to the Code in 1962 at the same time as the CFC provisions. In enacting the FIC provisions, Congress intended to stop the avoidance of tax by investors in foreign investment companies.[17] In 1962, as today, a domestic investment company was required to distribute at least 90% of its earnings in order to escape the imposition of a corporate level tax.[18] Shareholders of a domestic regulated investment company therefore paid a single tax on the earnings of the company. A foreign investment company and its shareholders, however, generally paid no U.S. income tax on a current basis, since U.S. tax was imposed on foreign corporations only on income derived from sources within the United States, and such companies generally had no U.S. securities and distributed no dividends. The U.S. shareholders therefore were subject to a U.S. tax on their investment in the foreign investment company only when their stock was sold, enabling them to convert the ordinary earnings of the corporation into capital gains. In addition, those U.S. shareholders who held their stock in foreign investment companies until death could completely escape U.S. tax on the stock since a basis step-up would occur at date of death.

To remedy these abuses, §1246 of the Code provides that, upon sale or exchange of FIC stock by a stockholder, the taxpayer's ratable share of post-1962 earnings and profits up to the amount of the gain recognized is to be treated as ordinary, nondividend income. Unlike §1248, which treats the post-1962 E&P of a CFC as dividend income on sale of stock, no deemed paid foreign tax credits are available to a corporate taxpayer which holds 10% or more of the FIC's stock.[19] In addition, to limit the permanent avoidance at death which otherwise would be available on the sale of FIC stock, §1246(e) provides that the basis of stock received from the estate of a decedent must be reduced by the amount of the decedent's ratable share of the earnings and profits of the company accumulated after December 31, 1962. Upon sale of the stock, the heir would receive ordinary income in the amount of such earnings and profits but would be allowed a deduction for any estate tax paid which was attributable to inclusion in the decedent's estate of the amount taxed as ordinary income.[20]

A FIC is defined in §1246(b) to include: (1) any foreign corporation (a) registered under the Investment Company Act of 1940 as a management company or a unit investment trust (registered FIC) or, (b) if not so registered, any foreign corporation engaged in the business of investing, reinvesting or trading in securities (unregistered FIC); where (2) 50% or more of the total combined voting power of all classes of stock entitled to vote or the total value of all classes of stock is held directly or indirectly (by applying constructive ownership rules contained in §§318(a) and 958(a) [21] by United States persons. The

[10] Code §951(a)(1).
[11] TRA §1222(a).
[12] Section 951(b) was not amended by the TRA even though the stock ownership test of §957 was amended to include both value and voting power.
[13] Code §958(b).
[14] For the general operation of §1248 *see* Foster, 240 T.M., *Controlled Foreign Corporations - Section 1248.*
[15] Section 1248(d).
[16] The characteristics and operations of FICs are described at length in Lederman, 405 T.M., *Foreign Investment Companies - Section 1246.*
[17] S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 807.
[18] *See* Code §§851-855.
[19] *See* Code §1246(a)(2) and §902(a) and Regs. §1.902-1(a)(7).
[20] Code §1246(e)(2).
[21] These are less extensive than the attribution rules of §554.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

control test applicable to FICs under §1246(b) differs slightly, therefore, from that applicable to FPHCs and CFCs, in that status as a FIC will be triggered at any time when "50% or more", as opposed to "more than 50%" of the voting power or value or stock is held by U.S. persons. In addition, the U.S. persons holding FIC stock, as opposed to "U.S. shareholders" holding CFC stock, do not individually have to hold any specified percentage of the FIC stock in order for the foreign corporation to qualify as a FIC.

Unlike §1248, it is not possible, under §1246, to remove the taint of FIC stock by decontrolling it. Therefore, once the existence of control by U.S. persons and the investment business tests are met at any time during a U.S. stockholder's holding period, the later transfer of control to non-resident aliens will not enable a shareholder in a FIC to realize capital gain on sale under §1246. However, for sales or exchanges of FIC stock after August 13, 1981, a selling shareholder's ratable share of post-1962 earnings and profits does not include earnings and profits attributable to any year within the taxpayer's holding period in which the corporation was not a FIC, provided it was not a FIC in any year before such year and the corporation became a FIC because of its investment activities (*i.e.*, an unregistered FIC under §1246(b)(2)). Thus, the gain realized by a U.S. shareholder selling or exchanging stock of an unregistered FIC constitutes ordinary income only to the extent of the shareholder's ratable share of the corporation's E&P attributable to years after the corporation first became a FIC.

There is a means available to registered FICs, but not unregistered FICs, to have their U.S. stockholders exempt from taxation under §§1246, 1248 and Subpart F.[22] In order to avoid these provisions, the registered FIC must have elected, before 1963, to distribute to its stockholders 90% or more of its net worldwide income in each post-1962 year. The U.S. stockholders of electing FICs are entitled to pass-through treatment on the electing FIC's capital gains and to a deemed paid credit for foreign taxes paid by the FIC. The election places the FIC in a position comparable to that of a domestic regulated investment company.

II. Overview

All of the foregoing provisions, designed to prevent the deferral or avoidance of U.S. tax on the ordinary earnings from investments by U.S. shareholders in foreign corporations, might be avoided by any U.S. citizen who invested in a foreign corporation more than half of the stock of which was owned, taking into account constructive ownership rules, by non-resident alien individuals. For this reason,[23] Congress enacted new Code §§1291-1297 which prescribe new rules governing the treatment of certain passive foreign investment companies (PFICs).[24]

In general, the Tax Reform Act provides that U.S. shareholders who invest in a PFIC must pay both the U.S. tax and an interest charge related to the value of the tax deferral on the shareholder's investment at the time that the shareholder either disposes of his investment or receives an "excess distribution" from the PFIC. All gains recognized on disposition and all distributions received by the PFIC shareholder are taxed as ordinary income and are not eligible for the deemed paid foreign tax credit under §902.[25] Sections 1291 and 1293 provide some relief to U.S. shareholders who invest in PFICs which are "qualified electing funds." If a PFIC, under rules described below, elects to be a "qualified electing fund," the U.S. shareholders must include in gross income a share of the PFIC earnings and profits on a current basis and pay a shareholder level tax on those amounts. Where income is included currently under this election, the U.S. shareholder may retain the long-term capital gain character of income derived by the foreign corporation.

The new PFIC provisions do not repeal §§1246 and 1247. However, the PFIC provisions are not applicable to any corporation for which a §1247 election is in effect. In addition, §1246 shall not apply to the earnings and profits of any company for any taxable year beginning after December 31, 1986 if such company is a PFIC for such taxable year.[26] Since many foreign investment companies currently taxable as FICs under §1246 may be expected to meet the definition of PFIC contained in the new Code provisions, §1246 should be of limited application for taxable years beginning after December 31, 1986.

III. Detailed Analysis

A. Definition of PFIC

Section 1296 of the Code defines the term "passive foreign investment company" as any foreign corporation if (a) 75% or more of the gross income of such corporation for the taxable year is passive income or (b) the average percentage of assets by value held by the corporation during the taxable year which produced passive income or were held for the production of passive income is at least 50%. The PFIC thus is defined solely on an income and asset basis, as opposed to a stock ownership basis, defeating the attempts of U.S. shareholders to avoid the provision by placing 50 percent or more of the ownership of the foreign corporation in the hands of non-resident alien individuals.

1. Passive Income Defined

The term "passive income" is generally to have the same meaning as that term is used in amended Code §904, which defines passive income for purposes of the separate tax credit limitation.[27] Section 904 in turn refers to income of the type which would be "foreign personal holding company income" as defined in §954(c) of the Subpart F rules. Section 954(c), as amended by the Tax Reform Act,[28] defines the term "foreign personal holding company income" to include dividends, interest, rents, royalties and annuities.[29] In addition, foreign personal holding company income will include gains from the sales of property which does not generate active income, gains from certain commodity transactions, foreign currency gains not directly

[22] Code §1247.
[23] *See* Conf. Rep. No. 841, 99th Cong., 2d Sess., II-640-641 (1986)(hereinafter "Conf. Rep.").
[24] TRA §1235.
[25] *See* Code §1291(a)(5).
[26] Code §1297(b)(7).
[27] Code §1296(b)(1).
[28] TRA §1221(a).
[29] Code §954(c)(1)(A).

attributable to a transaction related to the business needs of the corporation, and any income "equivalent to interest."[30] The term "passive income" within the meaning of §954(c), however, does not include rents and royalties received from an unrelated person if derived from the active conduct of a trade or business, interest derived in the conduct of a banking business which is "export financing interest" as defined in §904(d)(2)(G), and certain "same country" dividend, interest, rent and royalty income received from a related person to the extent that such income does not reduce the payor's Subpart F income.[31]

The PFIC rules also contain an exception to the term "passive income" for (1) income derived in the active conduct of a banking business by an institution licensed as a bank in the United States, and (2) income derived in the active conduct of an insurance business by a corporation which would be subject to U.S. tax if it were a domestic corporation.[32] In addition, the conferees state that it is expected that bona fide underwriters of securities (who might otherwise be classified as PFICs because their assets consist of dividend-producing property) will be excluded from classification as a PFIC by reason of the dealer exception in §954(c)(1)(B), and because most of their income consists of commission income, which is not Subpart F income under §954(c).[33]

2. Look-Through Rule

In order that a foreign corporation should not be determined to be a PFIC merely by reason of holding stock in another foreign corporation, the statute provides a "look-through" rule in §1296(c) so that if a foreign corporation owns at least 25% in value of the stock of another corporation it will be treated as if it held its proportionate share of the assets of that corporation and received directly, rather than as a dividend, its proportionate share of the income of that corporation.

3. Start-Up Year Corporations and Corporations Changing Businesses

The statute provides relief from classification as a PFIC for those corporations which either are just beginning in business or changing businesses. Thus, under §1297(b)(2) a corporation will not be treated as a PFIC for the first taxable year in which it has gross income if: (a) no predecessor of the corporation was a PFIC; (b) it is established to the satisfaction of the Secretary that the corporation will not be a PFIC for either of the first two taxable years following the start-up year; and (c) such corporation is not in fact a PFIC for either of the first two taxable years following the start-up year. Similarly, under §1297(b)(3) a corporation which was not a PFIC for any prior taxable year, and which has disposed of one or more active trades or businesses within the taxable year (giving rise to substantially all of its passive income) shall not be treated as a PFIC by reason of investment of the proceeds of that disposition during the taxable year if it is established to the satisfaction of the Secretary that the corporation will not be a PFIC for either of the first two taxable years following the disposition year, and such corporation is not in fact a PFIC for either of such two taxable years.

This exception provides a breathing period for newly formed corporations and those which have sold all of their operating assets in anticipation of reinvesting the cash received on the disposition in a new trade or business. Such corporations may purchase portfolio securities in the interim period between the receipt of cash and its investment in operating assets. The provision thus adopts the approach of the District Court in *SEC v. Fifth Avenue Coach Lines, Inc.*[34] In this case a defendant corporation in October 1966 received $11.5 million in payment of a condemnation award for its operating assets. It placed the award in interest-bearing bank deposits. During October, November and December 1966, it purchased various portfolio securities. From January 1967 through June 1967 it continued to buy portfolio securities and, by June 1967, its cash balance declined to $1.6 million. In determining whether the corporation had violated the Investment Company Act of 1940 by failing to register as an investment company during 1966, the District Court noted that a company which has suddenly come into possession of a substantial amount of cash is entitled to a reasonable time to decide what to do with it without violating the Investment Company Act.[35] However, the court decided that, while the corporation was not an investment company at the end of 1966, it had become one by June of 1967.

A corporation which does not intend to become a PFIC and is considering the sale of its assets should plan to reinvest the proceeds of sale as quickly as possible in operating assets. The statute suggests a black-line test pursuant to which the corporation will have only the disposition year (or the start-up year) in which it may safely invest in passive assets.

B. Taxation of Shareholders of PFICs

1. General

Where it is established that PFIC status exists, every United States person who either receives an "excess distribution" or disposes of his stock in a PFIC during the taxable year must pay the United States tax attributable to the distribution or disposition *plus* an interest charge based on the value of the tax deferral as of the time of the distribution or disposition.[36] An interest charge is imposed on the value of the deferral, rather than taxing the earnings and profits of the PFIC directly to the U.S. shareholders as under the CFC rules, for the reason that U.S. persons taxable under the PFIC rules may not have, by reason of lacking control of the foreign corporation, the information necessary to determine the earnings and profits of the corporation or to force a distribution of such earnings and profits should the information be available.[37]

Where the taxpayer has received an excess distribution or has disposed of his stock in the PFIC, then under §1291(a) the amount of the excess distribution or the

[30] Code §954(c)(1)(B)-(E)
[31] Code §954(c)(2)(A), (B) and (C).
[32] Code §1296(b)(2)(A) and (B).
[33] Conf. Rep., *supra*, at II-644.
[34] 289 F.Supp. 3 (E.D.N.Y. 1968), aff'd, 435 F.2d 510 (2d Cir. 1970).
[35] 289 F.Supp. at 28.
[36] Code §1291.
[37] See S. Rep. No. 313, 99th Cong., 2d Sess. 394 (1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

amount of gain recognized on the disposition is considered to be allocated *pro rata* over the shareholder's holding period of his stock in the PFIC. Under §§1291(a) and (c), the tax due in the year in which the excess distribution or proceeds of disposition is received is the sum of (1) the tax imposed on the amount of the distribution or gain which is attributable to (a) the year of receipt (or disposition), (b) years in which the foreign corporation was not a PFIC, and (c) years prior to January 1, 1987; plus (2) the tax computed at the highest rate of U.S. tax for the investor on income attributed to prior years in which the foreign corporation was a PFIC; plus (3) interest on the deferred tax described in (2). All amounts so taxed are taxed as ordinary income. Where, however, the distribution or gain is not deemed to be an "excess distribution," the amount distributed will be subject to tax in the year of receipt under normal Code rules, with the exception referred to above, that distributions from a PFIC will not be eligible for the deemed paid foreign tax credit under §902 of the Code.

a. Excess Distributions

A distribution is an "excess distribution" to the extent that it represents a distribution in excess of 125% of the average amount of distributions in respect of the stock during the three preceding taxable years.[38] If the taxpayer did not hold the stock during the three preceding taxable years, then the 125% amount is calculated on the basis of the average amount received during the period that the taxpayer did hold the stock, before the taxable year. The statute provides, however, that there shall be no excess distribution with respect to stock in a PFIC during the year in which the taxpayer's holding period begins.[39]

(i) Allocation of Excess Distribution

An excess distribution is allocated to each day in an investor's holding period with respect to each share of stock for purposes of determining the amount of tax and interest due on receipt of the excess distribution.[40] The conferees explain that this rule is necessary since an investor may have different holding periods with respect to his or her investment and a fund may distribute earnings more than once during a taxable year.[41] While the statute states that determinations with respect to holding period and annualization of distributions are to be made pursuant to regulations (*see* §1291(f)), the conferees provide an example of the application of the rule in a case where distribution is made on two different days of the taxable year as follows:[42]

"... [A]ssume an investor's average distributions for the three prior years are $100 and the investor receives a $100 distribution in the first month of the year and a $50 distribution in the 11th month of the year. The total excess distribution of $25 is to be allocated two-thirds to the first month and one-third to the 11th month for purposes of attributing the excess distribution to the current year and prior years for computing the investor's deferred tax and interest." [43]

The taxpayer in the foregoing example presumably thereafter would compute the aggregate increase in taxes and the aggregate amount of interest attributable to the excess distribution by making two separate computations. In the first computation, two-thirds of the $25, or approximately $16.65, would be allocated to the first month of the year and prorated on a daily basis over the taxpayer's holding period for the stock. The remaining one-third, or approximately $8.35, would be allocated to the 11th month, and prorated on a daily basis over the taxpayer's holding period for the stock. The example would become even more complex in a case where the taxpayer had different holding periods for different portions of his stock. In that case, additional computations would be required to further break down the allocation of the excess $25.

(ii) Computation of Deferred Tax Amount

If the taxpayer determines that he has received an excess distribution for the taxable year (*i.e.*, if the amount of the distribution is greater than 125% of the average amount received in respect of such stock during the three preceding taxable years), the second step is to determine the "deferred tax amount" attributable to the excess distribution.[44] First, as noted above, the excess distribution is allocated on a daily basis to each day of the taxpayer's holding period. That portion of the excess distribution which is attributable to the current year is subject to tax in the current year under normal Code rules, as is that portion of the distribution which is not "excess." The remainder is allocated to previous taxable years during which the taxpayer has held the stock and is subject to tax at the highest rate of tax in effect for each such taxable year during the holding period.[45] The taxpayer then computes the amount of interest on the amounts attributed to prior taxable years during which the taxpayer held the stock using the interest rate which was in effect under §6621 for underpayments of tax for each such period. Interest is determined beginning on the due date for filing the return for each taxable year during the holding period and ending on the due date for the taxable year with or within which the distribution or disposition occurs.[46]

The foregoing rule may be illustrated by the following example, in which it is assumed that a $1,500 distribution was received on December 31, 1991. In this example, the investor's average distribution for the three prior taxable years was $1,000. The taxpayer has held all shares of stock for a total of five taxable years beginning on January 1, 1987, during all of which years the corporation was a PFIC. The total excess distribution in this case is $250 ($1,500 received during the taxable year less $1,250 [125% times $1,000]). Approximately $50, or one-fifth of the excess distribution, should be allocated, on a daily basis, to each of the five taxable years (including the current year) during which the taxpayer held the stock. Therefore, the

[38] Code §1291(b).
[39] Code §1291(b)(2)(B).
[40] Code §1291(b)(3).
[41] Conf. Rep., *supra*, at II-642.
[42] *Id.*
[43] *Id.* The $25 amount is obtained by multiplying $100 by 125% and subtracting the result from $150.
[44] Code §1291(c).
[45] Code §1291(c)(2).
[46] Code §1291(c)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

tax due on the distribution should be computed by adding the sum of the tax due on $50 (from 1987) plus interest compounded for four years, the tax due on $50 (from 1988) plus interest compounded for three years, the tax due on $50 (from 1989) plus interest compounded for two years, the tax due on $50 (from 1990) plus interest compounded for one year, and the tax due on $1,300 ($1,250 non-excess distribution plus $50 excess distribution attributable to 1991) on which no interest would be due. If, during 1987, the corporation had not been a PFIC, the $50 from year one would be added to the current year's income with no interest charge being imposed on such amount.[47] The same result would ensue if the taxpayer's holding period had included years prior to January 1, 1987 and the corporation became a PFIC on that date.[48]

The rules for calculating the "deferred tax amount", as illustrated in the above example, represent a change by the conferees from the Senate version of H.R. 3838. Under the Senate version, the entire $1,500 received in year five would have been allocated to current and past years in the approximate amount of $300 per year.[49] In incorporating the "excess distribution" concept, the conferees intended to give relief to investment funds which currently distribute all of their ordinary earnings, for which there is no tax deferral.[50]

While the "excess distribution" concept is used to determine the amount of the inclusion in the taxpayer's gross income for the current year of any distribution received with respect to PFIC stock, for purposes of claiming any withholding tax as a foreign tax credit, the total amount of the distribution, including any excess, is included in gross income in the year of receipt.[51]

b. Dispositions

Section 1291(a)(2) of the Code states that gain recognized from the disposition of stock in a PFIC is to be treated in the same manner as if such gain were an "excess distribution". The amount of the gain, therefore, presumably should be allocated ratably to each day in the taxpayer's holding period for the stock, ending on the date of disposition.[52] In the above example, had the taxpayer recognized a $1,500 gain on the sale of PFIC stock on the last day of the taxable year, and if the taxpayer had held the PFIC stock for five taxable years, then the gain would be deemed to have been earned $300 in each of years one through five and would generate a tax and interest charge calculated in the same manner as an excess distribution.

(i) "Deemed Dispositions"

The Code states that the term "disposition" shall include the pledge of any stock in a PFIC as security for a loan.[53] A "disposition" also will be deemed to occur where a United States person who is treated as holding stock in a PFIC by reason of the constructive ownership rules discussed below is no longer treated as holding such stock either because he has disposed of his interest in an intervening entity through which the stock of the PFIC was attributed to him or because the person or entity from which ownership of the PFIC stock was attributed to the taxpayer has disposed of such stock.[54]

If the taxpayer owns stock in a PFIC on the first day of a taxable year beginning after December 31, 1986, in which the PFIC elects to become a "qualified electing fund" (as discussed below) the taxpayer may elect to recognize gain as if he had disposed of his stock on the first day of such taxable year for its fair market value ("mark to market election").[55] The taxpayer making this election must pay all prior deferred tax and interest attributable to the stock over the period of his holding period, and may acquire a new basis and holding period in the PFIC, and thereafter be taxed under the special rules applicable to qualified electing funds.[56] A taxpayer electing to mark to market his PFIC stock in this manner may increase the basis of his stock in the PFIC by the gain recognized as a result of the election.

The Code does not otherwise define the term "disposition", and it is anticipated that regulations will be needed to further define that term. Under §§1246 and 1248, for example, gain from a "deemed" sale or exchange under §§302 and 301 will be taxed as ordinary income. If a §302 distribution from a PFIC is treated as a "disposition", then the amount of gain recognized would be apportioned between current and past years under the statute. If, however, the §302 distribution is treated as a dividend, it presumably would fall within the rules applicable to distributions, and that portion of the entire distribution in excess of 125% of the three prior years' average distributions would be allocated between current and past years.

(ii) Basis and Holding Period

In determining the amount of gain which shall be treated as an excess distribution upon any disposition of PFIC stock by a taxpayer, the Code provides that basis is to be determined by reference to rules in effect with respect to FICs under §1246 and the taxpayer's holding period is to be determined under the general rules of §1223.[57] Under the principles of §1246, stock, the basis of which is determined by reference to stock of a PFIC, will also be considered PFIC stock, and the holding period for such stock will include the holding period of the prior owners.[58] If a taxpayer's holding period includes the holding period of prior owners, distributions received by the prior owners shall be taken into account in determining the amount of any excess distribution received by the taxpayer.[59]

The Code requires a reduction in the basis of stock in a PFIC which is acquired by bequest, devise or inheritance amounting to fair market value at date of death reduced by

[47] Code §1291(a)(1)(B)(ii).
[48] *Id.*
[49] *See* S. Rep. No. 313, 99th Cong., 2d Sess. 396 (1986).
[50] *See* Conf. Rep., *supra*, at II-642.
[51] Code §1291(a)(4); Conf. Rep., *supra*, II-642.
[52] Code §1291(a)(1)(A). Where there is a distribution rather than a disposition, the Code states that the taxpayer's holding period shall be treated as ending on the date of such distribution for purposes of calculating the amount of the distribution allocated ratably to each day in the taxpayer's holding period for the stock. *See* Code §1291(a)(3)(A).
[53] Code §1297(b)(6).
[54] Code §1297(b)(5).
[55] Code §1291(d)(2)(A).
[56] *See* Conf. Rep., *supra*, at II-643.
[57] Code §§1291(a)(3) and 1291(e).
[58] Code §§1291(e) and 1246(c).
[59] Code §1291(b)(3)(D).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the adjusted basis of the stock immediately before the decedent's death.[60] This reduction is not to apply, however, in the case of a decedent who was a non-resident alien at all times during his holding period in the stock.[61] The basis deduction is designed to prevent the avoidance of U.S. income tax on PFIC stock by holding such stock until death in anticipation of receiving a step-up in basis.

C. Taxation of Qualified Electing Funds

Under new §1293 of the Code, every United States person who owns, actually or constructively, stock of a "qualified electing fund" at any time during the taxable year must include in income his *pro rata* share of the ordinary earnings and net capital gain of the fund for each year. The provision thus treats a PFIC which is a qualified electing fund in a manner similar to CFCs and FPHCs in that earnings of the foreign corporation will be taxed on a current basis to the actual or constructive owners of the foreign corporation's stock. The advantages to an investor of including income on a current basis generally are two-fold: first, the investor may retain the long-term capital gain character of income derived at the PFIC level; and second, 10% corporate shareholders of a PFIC which is a qualified electing fund are permitted under §1293(f) to claim the deemed paid foreign tax credit under §960 of the Code.

Amounts included in the income of a shareholder of a qualified electing fund increase the shareholder's basis in his stock.[62]

1. Previously Taxed Amounts

If a PFIC makes a distribution of earnings which were previously included in income of any shareholder under the general rule applicable to qualified electing funds, then the distribution is tax-free to the recipient.[63] However, the shareholder's basis in his PFIC stock is reduced in the amount of the previously taxed distribution.[64] This rule highlights the importance of tracing the previous ownership, earnings and tax history of PFIC stock, since the purchaser of such stock who receives a distribution may otherwise be unable to determine whether such distribution was previously subject to tax while held by another person.

Under new Code §986(c), gain or loss realized as the result of currency fluctuations between the time of a deemed distribution from a qualified electing fund and the time of actual distribution must be recognized as ordinary income or loss at the date of distribution. The gain or loss will be sourced in the same manner as the related income inclusion.

2. Manner of Making Election

Under §1295 of the Code a PFIC may make an election to be a qualified electing fund for any taxable year. Once made, the election shall apply to all subsequent taxable years of the corporation for which it is a PFIC, and may be revoked only with the consent of the Secretary.[65] An election may be made for any taxable year at any time before the 15th day of the third month of the following taxable year. Since the PFIC amendments apply generally to taxable years of foreign corporations beginning after December 31, 1986, corporations will have over a year from the enactment date of the TRA (October 22, 1986) in which to decide whether to elect to be a qualified electing fund.

Under §1295(a), PFIC making the election must comply with such requirements as the Secretary may prescribe by regulation for purposes of determining the ordinary earnings and net capital gain of the corporation for the taxable year and ascertaining the ownership of its outstanding stock. In explaining this requirement, the conferees stated that "it was essential to allow the Internal Revenue Service adequate access to information about U.S. investments in foreign investment funds before U.S. shareholders of those funds receive flow-through of capital gain income and attribution of ordinary income to a particular taxable year."[66] The conferees further state that if a qualified electing fund fails to meet its compliance obligations (to be prescribed by regulation at some future date), it is intended that all U.S. investors be treated as having disposed of their stock in the fund and that the corporation's election to be a qualified electing fund be revoked.[67]

3. Shareholder Level Election to Extend Time for Payment of Tax on Undistributed Earnings

Section 1294 of the Code allows a taxpayer who is an investor in a PFIC which is a qualified electing fund to defer, subject to an interest charge, U.S. tax on amounts to be included in income for which no current distributions are received. The reason for this election is that U.S. investors may not have sufficient ownership in the PFIC to compel distributions.[68] If the shareholder makes this election, then the tax must in all events be paid at such time that the stock in the PFIC is disposed of or the PFIC ceases to be a qualified electing fund. If a shareholder receives a distribution which is not includible in income by reason of having been included in income for a prior year (§1293(c)), but the taxpayer had deferred the tax on such amount in the prior year by means of the election, then the deferral on such amount terminates at the time for filing the return for the year of distribution.[69]

A shareholder may make an election to defer the tax not later than the time prescribed by law (including extensions) for filing his return for the taxable year.[70] The running of the statute of limitations is suspended with respect to the tax on the undistributed amounts during the period of the deferral.[71] As with any extension under Code §6165, the Secretary may require a bond conditioned upon the payment of the amount of the tax extended. In addition,

[60] Code §1291(e)(1).
[61] Code §1291(e)(2). There is a clerical error in this section which must be corrected by subsequent legislation. The section should read "(2) such a reduction shall not apply in the case of a decedent who was a non-resident alien at all times during his holding period in the stock."
[62] Code §1293(d)(1).
[63] Code §1293(c).
[64] Code §1293(d)(2).
[65] Code §1295(b).
[66] Conf. Rep., *supra*, at II-643.
[67] *Id.*
[68] *Id.*
[69] Code §1294(c)(2)(A).
[70] Code §1294(d).
[71] TRA §1235(d), amending Code §6503.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

if the Secretary believes that the collection of the tax is in jeopardy, he may immediately terminate the extension with respect to such amount and notice and demand for payment may be made.[72]

An election is not available to a shareholder with respect to any undistributed PFIC earnings of a qualified electing fund which are required to be included in income currently under the FPHC rules (§551) or the Subpart F rules (§951).[73] U.S. shareholders of FPHCs or CFCs by definition have control of the foreign corporation, and thus the rationale for permitting the election (*i.e.*, lack of power to compel distributions) does not apply.

D. Attribution Rules

The PFIC provisions, like those applicable to FPHCs, CFCs and FICs, contain their own set of attribution rules pursuant to which a shareholder in a PFIC will be taxed on its earnings according to his proportionate share of direct and indirect ownership in the foreign corporation.[74] The PFIC attribution rules are much less extensive, however, than those applicable to other foreign entities. The reason for this undoubtedly is that control of the foreign corporation is irrelevant to the determination of PFIC status, and the only purpose of the attribution rules, therefore, is to determine the amount of income of the PFIC which is to be taxed to United States persons.

First, §1297(a) states that the attribution rules, except to the extent provided in regulations, shall only apply to attribute stock of a PFIC to a United States person and not to treat stock owned actually or constructively by a United States person as owned by any other person. The rules therefore provide only for attribution from corporations, partnerships, estates and trusts to their shareholders, partners or beneficiaries. The result is to prevent the avoidance of the PFIC rules through the interposition of a foreign entity between the U.S. person and a PFIC. Unlike the FPHC and CFC rules, there is no family attribution under the PFIC rules.

1. Attribution From Corporations

a. Attribution From 50% Owned Corporations

Section 1297(a)(2)(A) of the Code provides that in determining stock ownership, a U.S. person is considered to own his proportionate share of the stock of a PFIC owned by any corporation if the U.S. person owns 50% or more of the value of such corporation's stock. For example, if a U.S. person owns 60% of the stock of corporation X (a non-PFIC), and corporation X owns 20% of corporation Y (a PFIC), then the U.S. person will be considered to own 12% (60% times 20%) of corporation Y. Therefore, if the PFIC is a qualified electing fund, the United States person will be required to include in income 12% of the ordinary earnings and net capital gain of such fund for the year.[75]

As noted above, §1297(b)(5) of the Code also provides that any disposition by a United States person, or the person holding stock attributed to a United States person, which results in the United States person being treated as no longer holding such stock, shall be treated as a disposition by the United States person of stock in the PFIC. In the foregoing example, therefore, if the United States person to whom 12% of the ownership of corporation Y (a PFIC) was attributed, were to dispose of his stock in corporation X (a non-PFIC), presumably 12% of the gain recognized by the United States person on disposition of the X stock would be taxed under the PFIC rules. The Code does not, however, provide rules for the taxation of dividend distributions under the "excess distribution" rules reflected in §1296, where a U.S. person to whom the stock of a PFIC is attributed (through a non-PFIC corporation) receives a distribution from the intervening corporate entity. Clearly, the intervening corporate entity would be required, under §1291, to include and allocate on a ratable basis to each day in its holding period any distribution from the PFIC. Whether this distribution is also to be considered to be received by the U.S. person owning stock in the intervening corporation is unclear from the statute.

b. Attribution From Less Than 50% Owned Corporations

If follows from the above passage that where the U.S. person does not own at least 50% in value of the stock of a non-PFIC corporation, any PFIC stock owned by that corporation will not be attributed to the U.S. person. Therefore, in the foregoing example, if the U.S. person had owned 20% of the stock of corporation X (a non-PFIC) and corporation X had in turned owned 60% of the stock of corporation Y (a PFIC), the stock of corporation Y would not be attributed to the 20% owner of corporation X. There is one exception to this rule, however, contained in §1297(a)(2)(B) of the Code. Under this exception, if corporation X is a PFIC, then the 50% limitation is disregarded for purposes of determining whether the U.S. shareholder is treated as owning stock owned directly or indirectly by corporation X.

2. Attribution From Partnerships, Trusts and Estates

Section 1297(a)(3) states that stock owned directly or indirectly by or for a partnership, estate or trust shall be considered as being owned proportionately by its partners or beneficiaries. Unlike corporate attribution described above, there is no 50% limitation applicable to ownership of a partnership, estate or trust.

3. Reattribution

The Code provides in §1297(a)(4) that stock which is owned by a person indirectly by reason of attribution from a corporation, partnership, estate or trust shall be considered as actually owned by such person for purposes of reattribution. For instance, if a U.S. person owned 20% of partnership A, which in turned owned 60% of corporation X (a non-PFIC), which in turned owned 20% of corporation Y (a PFIC), then the 12% ownership attributed to partnership A (*see* example above) by reason of Code §1297(a)(2)(A), would be reattributed to the U.S. partner of partnership A under §1297(a)(3) in the amount of his proportionate ownership of partnership A. This attribution would amount to 2.4% (20% times 12%).

[72] Code §1294(c)(3).
[73] Code §1294(a)(2).
[74] Code §1297.
[75] Section 1293(a)(1)(A) and (B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

4. Separate Interests Treated as Separate Corporations

Section 1297(b)(4) of the Code states that pursuant to regulations, separate classes of stock (or other interests) in a corporation may be treated as interests in separate corporations. The reason for this provision, as stated in the Senate Report,[76] is that the ownership attribution rules of the bill might otherwise be circumvented in a case where a U.S. person owned less than 50% of a corporation which was not a PFIC. Such a corporation could issue a separate class of stock and use the proceeds to invest in a PFIC (or invest directly). The corporation, if engaged in an active trade or business, probably still would not be a PFIC under the general definition contained in §1296. However, the Senate states, in these instances, "it may be necessary to treat the separate issue of stock as a separate corporation ... In that event, the separate corporation will in all likelihood be a PFIC and the attribution rules will attribute any lower-tier PFIC stock to the ultimate U.S. investors." [77]

E. Coordination With Other Code Sections

As noted above, numerous other sections deal with the tax treatment of foreign corporations owned in part by U.S. persons. In many cases, these sections will overlap with the new PFIC provisions. This will be particularly true where five or fewer U.S. persons own 50% or more of the vote or value of a PFIC. The Act therefore provides several rules to coordinate the application of these sections with the PFIC rules.

First, where income would be includible in the gross income of a United States shareholder under both the Subpart F and the PFIC rules, it shall be includible only under Subpart F.[78] This situation may be expected to occur in any case in which five or fewer U.S. persons own 50% or more of the vote or value of a PFIC.

Second, amounts includible under both the PFIC and the FPHC provisions shall be includible only under the FPHC provisions.[79] This situation may be expected to occur where more than 50% in value of the outstanding stock of a PFIC is owned directly or indirectly by or for not more than five individuals who are citizens or residents of the United States.

Third, §1246, which governs the taxation of FICs as opposed to PFICs, shall not apply to the earnings and profits of any company for taxable years beginning after December 31, 1986 if such company is a PFIC for such taxable year.[80] A FIC may be a PFIC in any taxable year in which 75% or more of the gross income of the FIC is passive income or the average percentage of assets by value held by the FIC during the taxable year which produce, or are held to produce, passive income is at least 50%. Since FICs are by definition engaged in the business of investing, reinvesting and trading in securities, many FICs will fall into the PFIC category. The TRA also amends §1246 to clarify that that section does not apply to any gain to the extent that it is treated as ordinary income under §1248. [81]

F. Miscellaneous

Section 1235(f) of the TRA makes several amendments to clarify that a PFIC is not to be subject to the accumulated earnings tax [82] and is not to be subject to the personal holding company (PHC) provisions [83] or the regulated investment company (RIC) provisions.[84] The Act also contains a rule to resource PFIC income inclusions as U.S. source if the PFIC is a United States-owned foreign corporation and the PFIC receives U.S. source income.[85]

G. Regulations Needed

Numerous sections of the TRA provisions on PFICs indicate the need for regulations to be prescribed by the Secretary within the near future. Among the areas of concern are the following:

1. The manner in which the excess distributions are to be determined on a share-by-share basis;

2. The manner in which proper adjustments shall be made for stock splits and stock dividends;

3. The manner in which distributions received during the taxable year will be annualized in cases where the taxpayer does not hold the stock during the entire taxable year;

4. The manner in which distributions received by another person shall be taken into account by the taxpayer where the taxpayer's holding period includes periods during which the stock was held by that other person;

5. The manner in which distributions received in foreign currency shall be treated;

6. The extent to which gain shall be recognized under the PFIC provisions on any disposition which otherwise might be a non-recognition transaction under another section of the Code;

7. The manner in which the ordinary earnings and net capital gain (as well as the E&P) of PFIC are to be determined;

8. The reporting requirements applicable to qualified electing funds;

9. The extent to which stock owned or treated as owned by a United States person may be attributed to any other person;

10. The extent to which separate classes of stock (or other interests) in a corporation shall be treated as interests in separate corporations;

11. The extent to which a disposition of stock by a United States person to whom ownership in a PFIC is attributed, or a disposition of such stock by the entity from which stock is attributed to a United States person, is

[76] S. Rep. No. 313, 99th Cong., 2d Sess. 398 (1986).
[77] *Id.*
[78] TRA §1235(c) amending Code §951.
[79] TRA §1235(e) amending Code §551.
[80] Code §1297(b)(7).
[81] Act §1235(b).
[82] TRA §1235(f), amending Code §532(b).
[83] TRA §1235(f)(2), amending Code §542(c).
[84] TRA §1235(f)(3), amending Code §851(b).
[85] TRA §1235(f)(4)(A) and (B), amending Code §904(g)(1) and (g)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

treated as a disposition of PFIC stock by the United States person;

12. Clarification of what transactions are to be treated as dispositions as opposed to distributions for purposes of determining the amount, if any, of "excess distributions" which must be allocated to current and prior taxable years; and

13. Coordination of the attribution rules with §1291 of the Code where excess distributions are received by non-PFIC entities from which the stock of a PFIC is attributed to a U.S. person, or where excess distributions are received by U.S. persons from non-PFIC entities from which the stock of a PFIC is attributed to such persons.

Although §1246 was enacted in 1962, no Treasury Regulations under §1246 have been issued or proposed.

H. Effective Date

The PFIC amendments to the Code are applicable to taxable years of foreign corporations beginning after December 31, 1986. [86] With respect to qualified electing funds, the Code provides that the year of inclusion for a shareholder in such funds shall be the taxable year of the shareholder in which the taxable year of the fund ends.[87] It is probable, therefore, that calendar-year shareholders of non-calendar-year PFICs which elect to become qualified electing funds will have no inclusion in income of earnings of the fund until taxable year 1988. Further, pre-effective date earnings of PFICs are not treated as excess distributions for purposes of allocating distributions or gain on dispositions to current and prior years, and thus no interest charge is imposed on them.

[86] TRA §1235(h).
[87] Code §1293(a)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 65

NEW RULES GOVERNING THE TREATMENT OF DUAL RESIDENT COMPANIES [ACT §1249]

Deborah M. Beers, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

The United States imposes a tax on the worldwide income of its "domestic corporations," defined as any corporation created or organized in the United States or under the law of the United States or any State.[1] In the United Kingdom, however, which imposes a worldwide tax on the income of its resident corporations, the place of incorporation is not determinative of a corporation's residence for tax purposes. Instead, a corporation is considered to be resident in the country where its "central management and control" is situated. It is possible, therefore, for a corporation incorporated in the United States but managed and controlled in the United Kingdom to be subject to a worldwide tax on income, with corresponding tax credits, in both jurisdictions.

In the United States, a domestic corporation which is a member of an affiliated group may file a consolidated return on income with other members of the group, thus offsetting the income of one member against the losses of another.[2] The term "affiliated group" in turn means one or more chains of "includible corporations" connected through 80% or more stock ownership with a common parent corporation.[3] Only domestic corporations (*i.e.*, those incorporated in the United States or in any State) are eligible to be "includible corporations."[4] A dual resident corporation, since it is by definition incorporated in the United States, therefore would be permitted to consolidate with its U.S. affiliates.

A similar rule prevails in the United Kingdom where "group relief" is available to a company which is a member of a group of companies or is owned by a consortium.[5] Thus, losses of a corporation which is considered both a U.S. and U.K. resident (dual resident corporation) may be deducted twice — once against the consolidated income of the U.S. corporate group and once against the consolidated income of the U.K. corporate group. This practice, which is known as "double dipping" has encouraged the isolation of expenses in dual resident companies so that they may be used twice for tax purposes.

For example, a U.K. corporation, which is a member of a U.K. affiliated group which wishes to purchase a U.S. operating company, may do so by incorporating a subsidiary in the United States (dual resident company) which borrows money (usually from a U.K. bank) to finance the purchase. The interest incurred by the dual resident company on the amount borrowed to finance the purchase is, in effect, deductible twice — once against the income of the U.K. parent with which it is affiliated by reason of being operated and managed in the United Kingdom, and once against the income of the U.S. operating subsidiary. The same result would ensue should a U.S. company incorporate a dual resident company to acquire the assets of a U.K. operating subsidiary, as happened frequently in the 1970's when certain U.S. oil companies set up dual resident (U.K. managed but U.S. incorporated) subsidiaries to extract North Sea oil.

II. Overview

Section 1249 of the Tax Reform Act of 1986[6] amends §1503 of the Code to provide that the "dual consolidated loss" for any taxable year of any corporation shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year. The term "dual consolidated loss" is defined to mean any net operating loss of the domestic corporation which is subject to an income tax of a foreign country on its worldwide income or is subject to such a tax on a residence basis. It does not, however, include any loss which, under the foreign income tax law, may not be used to offset the income of another foreign corporation. The provision, as enacted, probably will affect only dual residents of the United States and the United Kingdom and Australia, although it is drafted in terms of general application.

As drafted by the Senate,[7] the amendment would have prohibited dual resident corporations from consolidating with other U.S. corporations when the income of the foreign corporation against which the dual resident corporation's loss might be used was itself not subject to U.S. tax.

[1] Code §7701(a)(3).
[2] Code §1501.
[3] Code §1504(a).
[4] Code §1504(b)(3).
[5] *See* generally, 68 T.M., *Business Operations in the United Kingdom.*

[6] P.L. 99-514, 99th Cong., 2d Sess., Oct. 22, 1986 (hereinafter sometimes "TRA").
[7] H.R. 3838, §983, S. Rep. No. 313, 99th Cong., 2d Sess., Part II, p. 1903 (May 29, 1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

As enacted, however, the provision prohibits the dual use of all losses, whether or not the foreign corporation against whose income the loss may be used will be subject to U.S. tax. This extension, as expressed by the conferrees,[8] was enacted both for reasons of fairness and to diffuse criticism of the Senate provision as discriminating against foreign-controlled U.S. entities by imposing on those entities a requirement for loss sharing not imposed on U.S.-controlled U.S. entities.[9] The conferees note, however, that if the provision is somehow found to conflict with the anti-discrimination provisions of any treaty, then the provision is to be effective notwithstanding the treaty.[10]

III. Detailed Analysis

A. General

As noted above, new Code §1503(d) prevents the use by any corporation of a "dual consolidated loss" to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year. A dual consolidated loss is defined to include:

> "[A]ny net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside such foreign country, or is subject to such a tax on residence basis."[11]

The effect of this provision is to prevent the use of any loss by a dual resident corporation to reduce the income of other members of the affiliated group. The provision does not, however, prevent the use of the loss to offset income of the dual resident corporation in other years, by means of a carryover of such loss against the separate income of that corporation.[12]

The provision adopts a rule preventing the use of the loss rather than preventing consolidation, as the Senate provision had suggested, since a rule preventing consolidation would have prohibited, in many cases, the application of the consolidated return rules to the U.S. subsidiaries of dual resident corporations under current regulations.[13] The effect of the amendment is therefore similar to the required application of the separate return limitation year (SRLY) rules[14] to prohibit the carryover or carryback of losses incurred by one member of a consolidated group against the income of other members of the group in separate return years.

B. Exception

Although the provision is targeted at those corporations which engage in "double dipping," it is not drafted in such a way as to exempt from its rules those dual resident companies which voluntarily do not transfer tax benefits to foreign affiliates as by, for example, foregoing "group relief" in the United Kingdom. However, there is a special rule which will apply, to the extent provided in regulations, to exempt from the definition of "dual consolidated loss" any loss which, *under foreign income tax law*, does not offset the income of any foreign corporation.[15] As an example of when this exception should apply, the conferees state that a U.S. corporation which resides in a foreign country, but has no affiliates in that country whose foreign tax its losses may reduce, and whose losses do not otherwise reduce the foreign tax of a foreign corporation should not be denied the use of the loss in its U.S. consolidated return.[16] Again, however, the exception is phrased in terms of whether the dual consolidated loss offsets the income of any foreign corporation "under the foreign income tax law," and not as a result of the voluntary choice of the dual resident corporation to forego the use of that loss. The exception would also appear not to apply in cases in which the loss was not used to reduce the income of the foreign affiliated group by reason of the foreign affiliated group's already being in a loss position for the taxable year. Instead, the exception appears to be restricted only to those situations in which the loss is unusable due to legal, as opposed to economic, factors.

C. Treaty Considerations

One difference between the final version of the bill and the Senate version is that the Senate version would have prohibited the use of the dual resident corporation's loss only where that loss could have been used to reduce the income of a foreign corporation all of the income of which was not subject to U.S. tax — generally foreign-controlled corporations. In contrast, the Act prohibits the use of all losses incurred by a dual resident corporation where such loss may be used to reduce the income of a foreign corporation, whether or not the foreign corporation is subject to U.S. tax. The application of this rule can be seen by the different results which would obtain under the Senate and final version of the TRA in a series of examples contained in the Senate Report.[17]

> *Example 1.* — A U.S. corporation owns a U.S.-U.K. dual resident corporation. The U.S.-U.K. dual resident company owns a U.S. subsidiary. The U.S.-U.K. dual resident company, a loss company, effectively transfers the U.K. tax benefit from its loss to its U.K. parent.
>
> *Example 2.* — A U.S. corporation owns a U.S.-U.K. dual resident corporation. The U.S.-U.K. dual resident company owns a U.K. subsidiary. The U.S.-U.K. dual resident company, a loss company, effectively transfers the U.K. tax benefit from its loss to its U.K. subsidiary.
>
> *Example 3.* — A U.K. corporation owns a U.S.-Australian dual resident corporation. The U.S.-Australian dual resident company owns a U.S. subsidiary and an Australian subsidiary. The U.S.-Australian dual resident company, a loss company, effectively transfers the Australian tax benefit from its loss to its Australian subsidiary.
>
> *Example 4.* — A widely held U.S.-U.K. dual resident corporation owns a chain of U.S. subsidiaries, a chain

[8] H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-657, Sept. 18, 1986 ("Conf. Rep.").
[9] *See* United States-United Kingdom Income Tax Convention (TIAS 9682) Article 24(5).
[10] Conf. Rep., *supra*, at p. II-658.
[11] Code §1503(d)(2)(A).
[12] *See* Conf. Rep., *supra*, at p. II-657.
[13] *Id.*
[14] *See, e.g.*, Regs. §1.1502-79.
[15] Code §1503(d)(2)(B).
[16] Conf. Rep., *supra*, p. II-657.
[17] S. Rep. No. 313, 99th Cong., 2d Sess., p. 422-423 (May 29, 1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

of U.K. subsidiaries, and a number of third country corporations. The U.S.-U.K. dual resident company, the ultimate parent, is a loss company. It effectively transfers the U.K. tax benefit from its loss to its chain of U.K. subsidiaries.

Example 5. — A U.S. corporation owns a U.K. corporation. The U.K. corporation owns a U.S.-U.K. dual resident corporation. The U.K. dual resident company, a loss company, effectively transfers the U.K. tax benefit from its loss to its U.K. parent.

Example 6. — A U.K. corporation with a U.S. permanent establishment and U.K. operations owns a U.S.-U.K. dual resident corporation. The U.S.-U.K. dual resident company owns a U.S. subsidiary. The U.S.-U.K. dual resident company, a loss company, effectively transfers the U.K. tax benefit from its loss to its U.K. parent.

The Senate bill would have disallowed consolidation, and thus the use of the loss against the income of U.S. affiliates, only in Examples 1 and 6 above, because in those examples the foreign-controlled entities would not have been subject to U.S. tax on all of their income. In contrast, under the TRA as enacted, the use of the loss is disallowed in all six factual situations. The reasons given by the conferees for extending the prohibition against use of the loss were first, that the extension was fair, and second, to diffuse criticism that the Senate provision discriminated against foreign-controlled U.S. entities by imposing on those entities some requirement for loss sharing not imposed on U.S.-controlled U.S. entities.[18]

As is the case with most income tax treaties, the U.S.-U.K. Tax Treaty, Article 24(5), prohibits the imposition of more burdensome requirements or taxation on foreign-controlled entities as opposed to domestic-controlled entities by stating that:

> "(5) Enterprises of [the United States], the capital of which is wholly or partly controlled, directly or indirectly, by one or more residents of [the U.K.], shall not be subjected in the [United States] to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of [the United States] are or may be subjected."

Critics of the provision as enacted point out that even though §1503(d) does not discriminate as between U.S.-controlled dual resident corporations and U.K.-controlled dual resident corporations, it nevertheless discriminates between the latter group of corporations and a similar group of U.S.-controlled U.S. corporations against which the U.K.-controlled dual resident corporation and its affiliates must compete. The conferees claim to find no merit in this argument,[19] for the purported reason that U.S.-controlled domestic corporations are not "similar enterprises" to U.K.-controlled dual resident corporations. This approach, however, is contradicted by the legislative history of the Treaty which suggests that dual resident corporations were specifically intended to be covered by the antidiscrimination clause of Article 24(5).[20] The conferees state that if the provision is somehow found to conflict with any treaty, the provision is to be effective notwithstanding the treaty.[21]

Despite criticism that the TRA provision discriminates against U.K.-controlled entities in violation of the tax treaty, there is some evidence that the United Kingdom also may take action to eliminate the benefits of the so-called "Delaware link" under the U.K. system of taxation.[22] Although originally reluctant to move against dual resident multinationals because such companies tended to borrow funds in London to finance their acquisitions of U.K. and U.S. operating companies, the Inland Revenue (the U.K. equivalent of the Internal Revenue Service) now estimates that exploitation of the benefits of dual residence causes a tax loss of about 200-300 million pounds a year.[23] It is likely, therefore, that some action against dual residents will be taken in next year's Finance Act.[24] If such legislation is phrased in such a way as to prevent the use of the loss of a dual resident U.S.-U.K. corporation to offset the income of any U.K. corporation, the effect of this provision under §1503(d)(2)(B) of the Code may be to permit the use of the loss against the consolidated income of the dual resident's U.S. group.

D. Effective Date

The amendment is effective in general with respect to net operating losses incurred in taxable years beginning after December 31, 1986. The conferees note that carryforwards attributable to losses incurred in years prior to 1987 by a dual resident corporation will be available to offset income that another member of the affiliated group earns in years beginning after 1986.[25] Losses incurred by a dual resident corporation in taxable years beginning after December 31, 1986 may, however, be carried forward only against the income of the dual resident corporation, and not against that of other members of its affiliated group.

[18] Conf. Rep., *supra*, at p. II-657-658.

[19] Conf. Rep., *supra*, at p. II-658.

[20] *See* Protocol (signed August 26, 1976) amending income tax treaty with United Kingdom (signed December 31, 1975, as amended by Notes exchanged at London on April 13, 1976); Second Protocol (signed March 31, 1977); and Amended Treasury Department Technical Explanation of U.S.-U.K. Income Tax Treaty (released on March 9, 1977, and revised on July 25, 1977 and October 25, 1979, as reproduced in Prentice-Hall, "Tax Treaties Vol. III, ¶89,000 *et seq.* (1986).

[21] Conf. Rep., *supra*, at p. II-658.

[22] *See* Wolman, "Revenue Action Likely Against Delaware Link Tax Loophole," *Financial Times*, p. 1 (Aug. 4, 1986).

[23] *Id.*

[24] *Id.*

[25] Conf. Rep., *supra*, at p. II-658.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 66

MODIFICATIONS TO §936 [ACT §1231]

Deborah M. Beers, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

A. Background

In 1940, Puerto Rico inaugurated "Operation Bootstrap" to encourage the growth of manufacturing enterprises within the Commonwealth. In pursuance of this goal, Puerto Rico has enacted a series of Industrial Incentive Acts, the most recent of which passed in 1978,[1] which exempt qualifying businesses from income and property taxes at the rate of 90% during the first five years of operation and decreasing thereafter in five-year intervals to 50%. The Puerto Rican incentives, taken together with those incentives provided by the Internal Revenue Code, encouraged the location of manufacturing enterprises, particularly in the pharmaceutical industry, in Puerto Rico, and thus contributed to the growth of employment in that Commonwealth.

Special provisions applicable to the taxation of possessions corporations have been a part of the Internal Revenue Code since 1921.[2] Under these provisions, a U.S. corporation which derived 80% or more of its gross income from a possession, and 50% or more of its gross income from the active conduct of a trade or business in the possession, was exempt from tax on all income derived from sources outside the United States, although dividends paid by a possessions corporation to its U.S. parent were fully taxable. This provision, substantially unchanged from its appearance in the Revenue Act of 1921, was enacted as §931 of the Internal Revenue Code of 1954.[3] Under §931, 80% or more of the gross income of the U.S. corporation had to be derived from sources within a possession of the United States [the "gross income test"], and 50% or more of its gross income had to be derived from the active conduct of a trade or business within a possession of the United States [the "active business test"], in order for the income exclusion to apply. The testing period was the 3 years immediately preceding the close of the taxable year (or that part of the 3-year period immediately preceding the close of the taxable year as may be applicable). As under the Revenue Act of 1921, under §931, no dividend exclusion was available to the corporate shareholder of a §931 corporation,[4] although its earnings could be distributed to the parent tax-free in the event of liquidation of the §931 corporation.[5] Therefore, a §931 corporation had no incentive to repatriate its earnings.[6] The determination of whether to use the §931 exclusion was made on an annual basis.

B. Section 936

Taxation of possessions corporations remained essentially unchanged until the Tax Reform Act of 1976.[7] The Act added a new §936 to the Code which provided a tax credit (in lieu of the exclusion under §931) of 100% of the U.S. tax due with respect to certain income received from those possessions corporations that make an election to benefit from the credit.[8]

1. Election

In order for a domestic corporation to be eligible for the §936 credit, an election must be made on Form 5712 on or before the date on which the corporation's federal tax return is due.[9] Once made, the election applies to the first taxable year for which such election is made (and thereafter until revoked)[10] for which the corporation satisfies a gross income and active business test for possessions corporations status under §936 (discussed below). Revocation before the election has been in effect for 10 years is possible only with the consent of the Secretary.[11] Revocation after the ten-year period is possible without the Secretary's consent.[12] Once the §936 election is made, a possessions corporation is ineligible to join in the filing of the consolidated return for any year in which the election is in effect.[13]

2. Eligibility for §936 Credit

The eligibility requirements for the §936 credit are similar to those for the §931 exclusion, *i.e.*:

---

[1] *See* Puerto Rico Industrial Incentive Act of 1963, Act No. 57 of June 13, 1963; Act No. 26 of June 2, 1978.
[2] Revenue Act of 1921, §262.
[3] P.L. 591, 83rd Cong., 2d Sess. (1954).
[4] *See* §246(a)(2)(B) prior the amendments made by the Tax Reform Act of 1976. Other Code section references in this chapter are to the Internal Revenue Code of 1986 unless otherwise specified; "pre-TRA" refers to Code sections prior to the Tax Reform Act of 1986.
[5] Pre-TRA §332.
[6] *See* H. Rep. No. 658, 94th Cong., 1st Sess. 254 (1975).
[7] P.L. 94-455, 94th Cong., 2d Sess. (1976).
[8] Pre-TRA §936(a)(1).
[9] Regs. §1.936-1(a).
[10] Pre-TRA§ 936(e)(1).
[11] Pre-TRA §936(e)(2)(A).
[12] Pre-TRA §936(e)(2)(B).
[13] Pre-TRA §1504(b)(4).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

a. Gross Income Test: 80% or more of the gross income of the possessions corporation for the 3-year period (or part thereof if the corporation has not been in existence for three years) immediately preceding the close of the taxable year must be derived from sources within a possession of the United States; and

b. Active Business Test: 65% or more of the gross income of the possessions corporation for such 3-year period or applicable part thereof must be derived from the active conduct of a trade or business within a possession of the United States.[14]

3. Amount of the Credit

If the possession corporation satisfies both the gross income and active business tests and elects the benefits of the §936 credit, it is allowed to credit against the U.S. income tax which is otherwise due on its worldwide income an amount equal to that portion of the U.S. tax which is attributable to the sum of:

a. The taxable income, from sources without the United States, from (1) the active conduct of a trade or business within a possession or the United States, or (2) the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business; and

b. The qualified possession source investment income (QPSII).[15]

A provision which was enacted in the forerunner of §931[16] and which carried over to §936 provides that, in determining the amount of taxable income for which a credit is available, any income received in the United States, whether it was derived from sources within or without the United States, is treated as income from sources within the United States, and thus is not eligible for the credit.[17]

"Qualified possession source investment income" is defined to mean gross income from sources within a possession in which an active trade or business is conducted if the taxpayer establishes to the satisfaction of the Secretary that the income is attributable to the investment or reinvestment in the possession, for use in the possession, of funds derived from the active conduct of a trade or business in the possession, less the deductions allocable thereto.[18] The regulations provide specific rules relating to the qualification of interest earned by a possessions corporation with respect to deposits with certain Puerto Rican financial institutions.[19] This special treatment for qualified investment income was provided so that the possessions would not lose (by the enactment of §936) a significant source of capital which they had available to them for the financing of government development programs and private investment.[20] The requirement that such income be derived from possessions sources was designed to ensure that the income would be used to promote the economy of the possession and to prevent the transfer of money from the United States to Puerto Rico to shelter it.

To prevent corporations from obtaining a double tax benefit, no credit or deduction is allowed with respect to any tax of a foreign country or possession that is paid or accrued with respect to taxable income taken into account in determining the §936 credit.[21]

4. Definition of "Possession of the United States"

The term "possession of the United States", as it appears in §936(d)(1) of the Code, includes the Commonwealth of Puerto Rico but does not include the Virgin Islands of the United States. For other purposes, "possessions" have been defined to include Midway Islands, Palmyra, Johnston Island, Kingman Reef, Wake Island, Howland Island, Baker Island, Jarvis Island and American Samoa.[22] However, for all practical purposes, the corporations availing themselves of the credit operate almost exclusively in Puerto Rico. In 1982, for example, the reduction in U.S. federal tax provided under §936 to all possessions corporations was approximately $1.66 billion, of which approximately $1.5 million was attributable to possessions corporations operating in locations other than Puerto Rico.[23]

C. Intercompany Transfer Pricing and Treatment of Intangibles

1. Section 482

In determining the transfer price for the sale of goods from a possessions corporation to a United States affiliate, the provisions of §482 are applied to require arm's length pricing. In 1963, the Service issued "guidelines"[24] to be followed in the application of §482 in cases involving the allocation of income and expense between U.S. companies and their manufacturing affiliates in Puerto Rico.

The Service specifically provided, however, that the guidelines did not deal with the problems that might be present in cases involving the transfer of income-producing intangibles to a Puerto Rican affiliate.[25] For that reason, the price received from a third party sale of goods manufactured in Puerto Rico might involve an allocation back to the U.S. parent if, for example, a part of the gross income received by the possessions corporation related to tangible or intangible property actually belonging to the United States parent.[26] The Service did provide pricing examples with respect to cases where the intangibles had been determined to belong to the U.S. parent, the possessions corporation, or to both the parent and the possessions corporation.[27]

[14] Pre-TRA §§936(a)(2)(A) and (B).
[15] Pre-TRA §936(a)(1). Note, however, that the credit is not allowed against minimum tax (§56), the accumulated earnings tax (§531), the personal holding company tax (§541), or the tax imposed by reason of a recovery of foreign expropriation losses (§1351), *see* Pre-TRA §936(a)(3).
[16] P.L. 98, 67th Cong., 1st Sess. §262(b) (1921).
[17] Pre-TRA §936(b).
[18] §936(d)(2).
[19] *See* Regs. §1.936-1.
[20] S. Rep. No. 938, 94th Cong., 2d Sess. 280 (1976).
[21] §§936(c) and 901(g).
[22] *See* Regs. §1.931-1 and Publication 570, Information for United States Citizens in Possessions of the United States, p. 1 (Nov. 1985).
[23] *See* Department of the Treasury, Fifth Annual Report on the Operation and Effect of the Possessions Corporation System of Taxation, pp. 58 and 79 (July 1985).
[24] Rev. Proc. 63-10, 1963-1 C.B. 490.
[25] *Ibid.* §1.
[26] *Ibid.* §3.02.
[27] *Ibid.*, §4.02-4.04.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

However, the question of whether intangibles belonged to the U.S. parent or the possessions corporation was a question "to be decided under the facts and circumstances of each particular case." [28] In *Eli Lilly Company and Subsidiaries v. Comr.*,[29] for example, the Internal Revenue Service unsuccessfully attempted to disregard the transfer, under §351 of the Code, of certain patents from a U.S. parent to its possession subsidiary for purposes of determining an arm's length price, under §482, for pharmaceutical products sold by the subsidiary to the U.S. parent.

Regulations under §482 with respect to the transfer or use of intangible property provide for an arm's length consideration to be paid which reflects the form (usually a royalty) which unrelated parties would have adopted in the circumstances.[30] The arm's length standard is consistent with that applied to determine the appropriate price of tangible property in sales between related parties.

In the case of sales of tangible property, the regulations set forth four methods of determining the arm's length price of a particular product. The first of these is the "comparable uncontrolled price method." [31]

The comparable uncontrolled price method fixes the arm's length price at the amount for which other unrelated buyers and sellers are trading the product in question. This method presupposes that other, uncontrolled sales of an identical product are taking place between unrelated buyers and sellers. While some courts have required a virtual identity of product and circumstance,[32] others have recognized that, in an imperfect market, an uncontrolled price may be determined where independent sales are "similar" although not identical to controlled sales.[33]

The second method prescribed by the regulations is the "resale price method." [34] This method is used where there are no comparable uncontrolled sales by the manufacturer. It is used most often where a controlled manufacturer sells a product to a controlling distributor which, without alteration or adding to the value of the product, resells it in the open market. The arm's length price is determined by reducing the price at which the product is resold by the distributor by an applicable percentage. This percentage is equal to the percentage of gross profit derived by the distributor on resales of similar products to unrelated third parties.

The third method described in the regulations is the "cost plus method." [35] The cost plus method is used when neither of the other two are appropriate. The arm's length price is determined by increasing the manufacturer's cost by a certain percentage which is equal to the manufacturer's gross profit percentage on similar products. The cost plus method differs from the resale price method in that it focuses on the manufacturer's customary profit percentage rather than on the distributor's. While this method is generally more suitable than the resale price method in cases in which the distributor performs important functions adding to the value of the product, it would not be appropriate where the manufacturer made no similar uncontrolled sales.[36]

Fourth, and finally, the regulations state that:

"Where none of the three methods of pricing described [above] can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described [above], or variations on such methods can be used." [37]

2. Code §367(d)

Prior to the amendment of Code §367 by TEFRA, intangible property could be transferred to a possessions corporation in an exchange under §351 of the Code without obtaining an advance ruling, since possessions corporations are domestic corporations. In 1982, TEFRA §213(d) amended Code §367 effective for all transfers after August 14, 1982 by a possessions corporation of any "intangible property." [38] Such transfers, whether made directly or indirectly, were treated, under the TEFRA amendments, as made pursuant to a plan having as one of its principal purposes the avoidance of Federal income taxes.[39] Thus, the Service could impose a "toll charge" on such transfer.

The Tax Reform Act of 1984 [40] again removed transfers of intangible property to possessions corporations from the scope of §367, effective for transfers or exchanges after 1984, in taxable years ending after 1984. Instead, the 1984 Act treats any transfer of intangibles to a foreign corporation (but not a possessions corporation) pursuant to §351 or §361 as a sale of the intangibles in exchange for "payments which are contingent upon the productivity, use or disposition of such property." [41] Section 367 thus incorporates the concept of an "arm's length" royalty payment from the regulations under §482.[42] Under these regulations, as described above, where intangible property is transferred for less than an arm's length consideration, the Commissioner may make appropriate allocations to reflect an arm's length consideration for the use of the property. Pursuant to Regs. §1.482-2(d)(4), the Commissioner will not make allocations, however, where there exists a "bona fide cost sharing arrangement" pursuant to which two or more members of a controlled group agree, in writing, to provide for sharing the costs and risks of developing intangible property in return for an interest in any intangible property which may be produced.

[28] *Ibid.*, §4.01. *See also* Regs. §1.482-1(d)(5).
[29] 84 T.C. 996 (1985).
[30] Regs. §1.482-2(d)(1) and (2). *See also Ciba-Geigy Corp. v. Comr.*, 85 T.C. 172 (1985).
[31] Regs. §1.482-2(e)(2).
[32] *See E.I. DuPont de Nemours and Company v. U.S.*, 608 F.2d 445, 455 (Ct.Cl. 1979), and *United States Gypsum Company v. U.S.*, 452 F.2d 445, 448 (7th Cir. 1971).
[33] *Cf. U.S. Steel Corporation v. Comr.*, 617 F.2d 942, 950 (2d Cir. 1980); *Eli Lilly and Company v. U.S.*, 372 F.2d 990 (Ct.Cl. 1967); and PLR 8122015.
[34] Regs. §1.482-2(e)(3).
[35] Regs. §1.482-2(e)(4).
[36] *Cf. Edwards v. Comr.*, 67 T.C. 224 (1976), acq., 1977-2 C.B. 1, where the Tax Court applied the cost plus method even though only one uncontrolled sale existed on which to base its determination.
[37] Regs. §1.482-2(e)(1).
[38] "Intangible property" was to be defined by reference to §936(h)(3)(B).
[39] *See* Code §367(d)(1) prior to its amendment by the Tax Reform Act of 1984, P.L. 98-369 §131(b), 98th Cong., 2d Sess. (1984).
[40] P.L. 98-369 §131(b), 98th Cong., 2d Sess. (1984).
[41] Pre-TRA §367(d)(2)(A)(i).
[42] *See* Regs. §1.482-2(d)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

3. Code §936(h)

In 1982, Congress, concerned about abuses alleged to be inherent in the transfer of intangibles to Puerto Rico, particularly in the pharmaceutical industry,[43] added a new §936(h) to the Code.[44] Generally, under §936(h), when a domestic corporation elects the application of §936, so-called "intangible property income" will be included, on a *pro rata* basis, in the gross income of all U.S. shareholders of the corporation.[45] Income which is not allocated to a shareholder because such shareholder is not a U.S. person or would not be subject to U.S. tax is treated as income of the possessions corporation which is derived from sources within the United States. Such income is subject to U.S. tax and no foreign tax credit is available with respect to the tax due on such income.

Generally stated, intangible property income consists of that portion of the gross earnings of the possessions corporation which is attributable to "intangible property". Such property includes so-called "manufacturing intangibles," such as patents, inventions and formulas,[46] as well as so-called "marketing intangibles", such as trademarks, trade names and brand names.[47] The statute assumes that such property was developed in the United States by the U.S. parent, still belongs to the U.S. parent, and therefore properly is subject to current domestic taxation. Thus, under the general rule of §936(h)(1) the only portion of the earnings of the possessions corporation which will be available for the §936 credit is that amount of income which a third party manufacturing entity would realize as a result of its performance of contract manufacturing services. Stated otherwise, the general rule of §936(h) represents a "cost plus method" (*see* discussion above) of determining taxable income.[48]

The Code offers two options as alternatives to the cost plus rule of §936(h)(3)(C). One of these is described as "cost sharing" [49] and the other as "profit split." [50] To be eligible to elect either the cost sharing or the profit split method, a possessions corporation must maintain a "significant business presence" in a U.S. possession.[51] To be eligible to elect the profit split method, corporations must also be engaged in "manufacturing" within the meaning of Code §954(d)(1)(A) (as if the possessions corporation were a controlled foreign corporation).[52]

a. Significant Business Presence Test

To meet the significant business presence test, one of three alternatives must be satisfied. Thus, the possessions corporation must incur in the U.S. possession in which the products are produced: (a) at least 25% of the total production costs (as defined); (b) not less than 65% of the direct labor costs; or (c) with respect to purchases and sales of products not produced by or sold to an affiliated member, at least 65% of the total direct labor costs.[53] Recently issued regulations [54] supply additional details concerning satisfaction of the significant business presence test.

b. Election Out

The election to apply either the profit split or the cost sharing method is treated under §936(h)(5) as an "election out" (*i.e.*, out of the "general rule" of §936(h)). Specific rules, contained in §936(h)(5)(F), prescribe the time and manner of making the election or a revocation thereof. This may occur with the filing of the return (including returns for which an extension of time has been granted) of the possession corporation. An election so made is binding (1) until revoked with the consent of the Commissioner or, (2) until the possession corporation fails to meet the significant business presence test, or (3) (in the case of an election to use the cost sharing method) until the cost sharing payment is not made at the time the return is filed (including returns for which an extension has been granted) and such failure is due to fraud or willful neglect.[55]

c. Cost Sharing Method

The cardinal principle of §936(h)(5) is a requirement that the possessions corporation share with its affiliates income earned on sales to the extent that such income relates to intangible property. "Sharing" is achieved, in the case of the cost sharing method, by the payment for a portion of the research, development, experimental and related costs to the appropriate domestic affiliates of the possessions corporation. Upon making this payment from the possession to the United States to account for the use of so-called "manufacturing intangibles", the possessions corporation is "treated as the owner" of the intangible property which relates to the units produced or the service rendered in the possession.[56] As deemed owner, the possessions corporation "will be entitled to the full return" on the products or services, but will be required to utilize §482 regulations, discussed above, to determine its applicable pricing.[57] The possessions corporation will not be treated as a contract manufacturer with respect to the intangibles for which the cost sharing payment is made.[58] Further, it may use the resale price method to determine its intercompany price even though more than an insubstantial value may

[43] S. Rep. No. 494, 97th Cong., 2d Sess. 158 (1982).

[44] Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") §213(a)(2), P.L. 97-248, 97th Cong., 2d Sess. (1982).

[45] Pre-TRA §936(h)(1)(A). An exception applies under Pre-TRA §936(h)(2)(A)(ii) for U.S. shareholders who are not subject to tax on the intangible property income which would be allocated to them.

[46] Pre-TRA §936(h)(3)(B)(i).

[47] Pre-TRA §936(h)(3)(B)(iii). Intangible property is defined in Pre-TRA §936(h)(3)(B)(i)-(vi).

[48] The possessions corporation is allowed a "reasonable profit" with respect to the products sold. *See* Pre-TRA §936(h)(3)(C). Recently promulgated regulations (T.D. 8090, 51 Fed.Reg. 21518 *et seq.*, June 13, 1986) state that certain taxpayers who have been permitted by the Internal Revenue Service in taxable years beginning before January 1, 1983 to use the cost plus method of pricing without reflecting a return from intangibles, but including the cost of materials in the cost base, will not be precluded from doing so. In addition, the Service has stated that if there is no intangible property related to a product produced in whole or in part by the possessions corporation, the taxpayer may compute its income using the appropriate method as provided under §482 and the regulations thereunder. Regs. §1.936-4, Q&A 3 and 4.

[49] Pre-TRA §936(h)(5)(C)(i).

[50] Pre-TRA §936(h)(5)(C)(ii).

[51] Pre-TRA §936(h)(5)(B)(i).

[52] Pre-TRA §936(h)(5)(B)(ii).

[53] *Id.*

[54] T.D. 8090, *supra.*

[55] Pre-TRA §936(h)(5)(F)(iii)(I) and (II).

[56] *See* §936(h)(5)(C)(i)(II).

[57] H. Rep. No. 760, 97th Cong., 2d Sess. 506 (1982). *See also* Regs. §1.936-6(a)(5), Q&A 13, 14, 15 and 16.

[58] *Id.*

have been added to the product by the purchasing affiliate.[59]

Section 936(h)(5)(C)(i)(I) articulates a mechanical formula for the determination of the amount of the cost sharing payment. Such amount is a fraction of the cost of the "product area research" paid or accrued by the affiliated group. "Product area research" includes the following items: (a) research, development and experimental cost;[60] (b) losses; (c) expenses; and (d) other "related deductions" which include (but presumably are not limited to) (1) amounts paid or accrued for research or "similar activities" performed by "another" (*i.e.*, presumably unrelated) person; (2) qualified research expenses within the meaning of §30(b); (3) amounts paid or accrued (such as through a license arrangement) for the use of, or the right to use, research or a patent, invention, formula, process, design, pattern or know-how;[61] or (4) a proper allowance for amounts incurred for the acquisition of any of the items in (3).[62]

All of the foregoing expenses are apportioned and allocated to the product area in which the possession corporation conducts its activities. The resulting "product area research" expenditures are thereafter multiplied by a fraction, the numerator of which is "possession sales" and the denominator of which is "total sales." The term "possession sales" includes the "aggregate sales or other dispositions" by any member of the affiliated group to unrelated parties of products produced in whole or in part by the possessions corporation (a) in the possession, and (b) within the product area.[63] "Possession sales" also include services rendered in whole or in part by the possessions corporation: (a) in the possession, (b) in the product area, and (c) to unrelated parties.[64] "Services" also include services "sold" by any U.S. or foreign affiliate to third parties if the services are rendered by the possessions corporation in the possession.[65] Effectively, "possession sales" (the numerator of the fraction) represents worldwide sales of possessions corporation products and services produced or rendered in the possession. Of course, interaffiliate sales are eliminated.[66]

The denominator of the fraction, or "total sales," is comprised of the "aggregate sales or other dispositions" to unrelated parties by any member of the affiliated group of all products or services rendered in the product area.[67] Again, the sales of products and services which are taken into account are those sales to unrelated parties by any member of the affiliated group. Thus (as in the case of the numerator), interaffiliate sales are eliminated.[68]

An example which calculates the cost sharing amount is as follows:

Product Area Research

R&D	100
Losses	10
Interest	10
Other Expenses	20
Indirect Expenses (G&A)	10
	150
Possession Sales	500
Other Sales	500
Total Sales	1,000

$500/1{,}000 \times 150 = 75$ (cost sharing payment)

Results:

a. Possession income = 500 (possession sales) - 75 = 425.

b. The U.S. parent will have its deductions decreased by 75 and its earnings and profits increased by 75.[69]

The statute expressly provides that the amount of the cost sharing payment, including any increased amount resulting from an adjustment upon audit,[70] is not treated as income to the domestic or foreign recipient. In lieu thereof, the amount of the payment reduces the deductions otherwise available if the cost sharing payment were not made. The amount of such payment also reduces the amount which would otherwise constitute a reduction in earnings and profits of any domestic (or foreign) recipient of the payment because of the deduction for research expenses.

d. Profit Split Method

A possessions corporation that has not made an "election out" of the cost plus method by making an election of the cost sharing method may elect the 50-50 "profit split" alternative. To be eligible for this alternative, a possessions corporation must meet the significant business presence test as is required for the cost sharing alternative,[71] plus its own §954 test.[72]

The possessions corporation's taxable income which is available for the profit split alternative is specifically limited to the amount of the corporation's taxable income which is derived from the active conduct of a trade or business in a possession. Thus, the taxable income derived from investment income (for example, dividends and/or interest derived from the investment of retained earnings) will not be eligible for the profit split alternative, but will be eligible for the §936 credit in its entirety.

[59] *See* §936(h)(5)(C)(i)(IV)(b).
[60] Pre-TRA §936(h)(5)(C)(i)(I)(a).
[61] Pre-TRA §936(h)(3)(B)(i).
[62] Pre-TRA §936(h)(5)(C)(i)(I)(a).
[63] Pre-TRA §936(h)(5)(C)(i)(I)(c).
[64] *Id.*
[65] H. Rep. No. 760, 97th Cong., 2d Sess. 507 (1982).
[66] *Id.*
[67] Pre-TRA §936(h)(5)(c)(i)(I)(d).
[68] H. Rep. No. 760, 97th Cong., 2d Sess. 507 (1982).

[69] Special treatment is provided for product area research paid or accrued solely by the possessions corporation. Such amounts reduce the electing corporation's cost sharing payment. Therefore, in the example above, if the possessions corporation has paid 20 (of the 100) R&D expenses to unrelated persons for work on its behalf, the $75 cost sharing payment would be reduced by 20 to 55 and the possession income would equal 445 (500 - 55), while the U.S. parent's deductions would be reduced by 55 and its earnings and profits increased by 55.
[70] Pre-TRA §936(h)(5)(C)(i)(III)(a) and (b).
[71] Pre-TRA §936(h)(5)(B)(i).
[72] Pre-TRA §936(h)(5)(B)(ii)(III).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The statute clearly establishes that the profit split alternative applies to taxable income derived with respect to "units of a product produced or type of service rendered" in whole or in part by the possessions corporation in a possession.[73] Combined taxable income is computed "separately" (*i.e.*, on a product by product basis) for each product produced or type of service rendered by the possessions corporation in a possession.[74] In computing combined taxable income, the gross income of the affiliated group (other than foreign affiliates) must be determined. The only includible income is that gross income derived from "covered sales", *i.e.*, sales of a particular product or service by members of the affiliated group (other than foreign affiliates) to unrelated parties or foreign affiliates.[75]

From the gross income derived with respect to covered sales there are deducted (i) those expenses, losses and other deductions which are "properly apportioned or allocated" to gross income, and (ii) a "ratable part" of those expenses, losses or other deductions which "cannot definitely be allocated" to some item or class of gross income, but which are incurred by any member of the affiliated group other than a foreign affiliate.[76]

Assuming that a valid profit split election is made, the possession corporation will be deemed to have derived from the active conduct of a trade or business in a possession 50% of the combined taxable income computed in the manner described above.[77] Such amount is of course eligible for the benefits of the §936(a) credit. On the other hand, there is allocated to the "appropriate" domestic member of the affiliated group the "balance" of the combined taxable income. For this purpose, however, combined taxable income is separately computed by determining combined taxable income using research, development and other expenses actually allocable to the product rather than the expenses which would have been allocable under the cost sharing formula, and which are used to determine combined taxable income for purposes of the profit split, and deducting from this amount income allocable to the possessions corporation. An example of the application of the profit split method appears in *Eli Lilly Company and Subsidiaries v. Comr.*[78] Although decided under §931, rather than §936, the decision in *Lilly* applied the principles of §936(h) to determine the combined taxable income of Eli Lilly and its Puerto Rican affiliate and to apportion such income between the two. The result was very close to the 50-50 profit split alternative under §936(h).

II. Overview

The Tax Reform Act of 1986 [79] makes five substantial modifications to the possessions tax credit as follows. (Authority for the following statements is given in the Detailed Analysis section which follows.) The changes include:

A. Modifications to Cost Sharing Payment

The cost sharing payment required by those possessions corporations electing to use the cost sharing method must equal the greater of (a) 110% of the payment required under pre-TRA law, or (b) an arm's length royalty which must be determined according to the principles of §§482 and 367. These two sections have in turn been amended by the Tax Reform Act to require that income with respect to intangibles transferred to a foreign related party must be commensurate with the income attributable to the intangibles.

B. Profit Split Method Modifications

Those corporations electing to use the 50-50 profit split method are required to increase by 20% the amount of product area research expenditures used for purposes of computing combined taxable income. The effect of this requirement will be to increase the amount of income allocable to U.S. affiliates by approximately the amount of increase under the Act for companies that elect the cost sharing option. The Act also makes a technical correction to the computation of combined taxable income under this method.

C. Receipt of Income Within the United States

The Act amends subsection (b) of §936 by modifying the requirement that income received within the United States (not including possessions thereof) is not eligible for the credit. Under the Act, a credit will not be denied simply by reason of such receipt, so long as the income is received from an unrelated party.

D. QPSII Redefined

The Act changes the definition of QPSII to include interest attributable to loans made by the Government Development Bank of Puerto Rico (GDB) and certain other financial institutions for investments or reinvestments in active business assets or development projects located in qualified Caribbean Basin Initiative (CBI) countries. The amendment thus expands QPSII to include income from investments in financial institutions which otherwise would be prohibited by the active business requirement of Code §936(b)(2).

E. Modification to Gross Income Test

The requirement of §936(a)(2)(B) that over 65% of the gross income of the possessions corporation must be from the active conduct of a trade or business in order for an electing corporation to claim the credit has been increased by the Act to 75% However, the present law requirement that 80% or more of gross income over a three-year period be derived from sources within the possession is unchanged.

Other miscellaneous changes, discussed elsewhere in this portfolio, include the repeal of the exemption of possessions corporations from the Subpart F provisions,[80] and the inclusion of the U.S. Virgin Islands in the definition of the term "possession of the United States."[81]

[73] Pre-TRA §936(h)(5)(C)(ii)(I).
[74] Pre-TRA §936(h)(5)(C)(ii)(II).
[75] Pre-TRA §936(h)(5)(C)(ii)(IV).
[76] Pre-TRA §936(h)(5)(C)(ii)(II).
[77] Pre-TRA §936(h)(5)(C)(ii)(III).
[78] 84 T.C. 996 (1985).
[79] P.L. 99-514 §1231, 99th Cong., 2d Sess. (Oct. 22, 1986).
[80] Act §1224 and Code §957(c).
[81] Act §1275 and Code §936(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

III. Detailed Analysis

In formulating their proposals for the revision of the Internal Revenue Code, both the Treasury Department [82] and the President [83] recommended that the possessions tax credit be repealed and replaced with either a permanent (in the case of the President's proposal) or a phased-out (in the case of the Treasury) wage credit. The reason given for the suggested repeal of the credit was that it was very costly and inefficient in that the average tax benefit per employee for all §936 corporations was approximately $22,000 in 1982, more than 50% more than the $14,210 average wage of possessions corporations employees.[84] In addition, it was noted that 14 corporations, which accounted for 4% of the §936 corporations for which employment data was available in 1982, derived 29% of the combined tax benefits from the credit, representing an average of $100,000 per employee.[85] In addition to being extremely costly and inefficient, the President and the Treasury noted that §936 was also exceedingly complex and difficult to administer, whereas a wage credit, by comparison, would prove much simpler to administer.

In amending, rather than repealing, the possessions tax credit, Congress was motivated in large part by representations made by the Government of Puerto Rico that it intends to pursue a certain "twin plant initiative" plan, currently in draft form, [86] pursuant to which the Government of Puerto Rico will guarantee $100 million annually of new funds for direct private investment in qualified Caribbean Basin countries. Under the twin plant initiative, corporations utilizing §936 in Puerto Rico would establish "twin plants" employing less skilled labor in nations in the Caribbean Basin for each Puerto Rican plant benefitting from §936. The modifications made by the Tax Reform Act to §936 therefore are directed at eliminating the more egregious abuses of that section by both reducing the amount of passive income eligible for the credit and increasing the amount of revenue derived from those corporations electing either the cost sharing or profit split method of computing income with respect to intangibles.[87]

A. Modifications to Cost Sharing Payments

Section 1231(a)(1) of the Act amends §936(h)(5)(C)(i)(I) of the Code by requiring the amount of the cost sharing payment for companies that elect that option to be at least 110% of the possessions corporation's share of product area research expenditures as computed under present law. In addition, under the same Code section, to the extent that this payment would be less than that required under amended §§367 or 482, a possessions corporation which elects the cost sharing option will be required to determine the size of that payment according to the principles of §§367 and 482.

In the example in I,C,3,c above, the effect of the required increase in the cost sharing payment would be as follows:

Product Research Expenditures	=	150
Possession Sales	=	500
Other Sales	=	500
Total Sales	=	1,000
Cost Sharing Payment Under Pre-TRA Law	=	75 (500/1,000 × 150)
Cost Sharing Payment Under TRA	=	82.5 (500/1,000 × 150 × 110%)

Results Under Pre-TRA Law

a. Possessions income = 500(possession sales) - 75 = 425.

b. The U.S. parent has its deductions decreased by 75 and its earnings and profits increased by 75.

Results Under TRA

a. Possessions income = 500 - 82.5 = 417.5.

b. The U.S. parent has its deductions decreased by 82.5 and its earnings and profits increased by 82.5.

The end result in the foregoing example is that 7.5 of income is shifted from the possession to the U.S. parent. However, if the determination of the cost sharing payment under this method would result in such payments being less than would have been required had the cost sharing payment been calculated under amended §§367(d)(2)(A)(ii) or 482, then the principles of those sections would have to be applied.

Under §§367(d)(2)(A) or 482, as amended by the Act,[88] where there is any transfer or license of intangible property, the income with respect to such transfer or license must be "commensurate with the income attributable to the intangible." [89] Under this standard, taxpayers will not be able to take into account only the facts and circumstances in existence at the time of the transfer of the intangible, but must reconsider, at intervals, the amount of the payment or royalty, given the actual profit experience realized as a consequence of the transfer.[90] Thus, if the IRS determines, based on hindsight, that the actual income attributable to an intangible from the manufacture and sale of a product is substantially greater than anticipated at the time of the transfer of the intangible it may increase the royalty income of the transferor at that time. It is unclear whether the taxpayer similarly may use hindsight to decrease the

[82] *See* Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth*, Vol. II, Chapter 15.05, p. 327 (Nov. 1984).

[83] Office of the President of the United States, *The President's Tax Proposal to the Congress for Fairness, Growth and Simplicity*, Chapter 12.05, p. 307 (May 1985).

[84] President's Proposal *supra*, p. 308.

[85] *Id.*

[86] *See* "Memorandum of Agreement Between the Government of the United States and the Government of Puerto Rico (Draft)," Nov. 14, 1985, cited in H. Rep. No. 426, 99th Cong., 1st Sess. 420 (1985) (hereinafter "House Report").

[87] See S. Rep. No. 313, 99th Cong., 2d Sess. 382 (1986) (hereinafter "Senate Report").

[88] *See* Act §1231(e).

[89] *Id.*

[90] House Report, 425.

royalty income attributable to the use of an intangible in those cases in which the income turns out to be substantially less than anticipated. At any rate, the addition of this factor to the computation of the cost sharing payment introduces an element of considerable uncertainty into the computation of the payment, and it may be anticipated that the cost sharing option will become less attractive in the future. The conferees do state, however, that in revising §482, it was not intended to preclude the use of certain bona fide research and development cost sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties.[91]

B. Profit Split Method Modifications

As noted above, §1231(a)(2) of the Act amends §936(h)(5)(C)(ii)(II) of the Code to provide that those corporations electing to use the 50-50 profit split method are required to increase to 120% the amount of product area research expenditures used for purposes of computing combined taxable income, an increase of 20%. Therefore, in the above example, product area research expenditures would be increased by $30 (20% x 150) to $180. Thus, the amount of income allocable to the U.S. parent would be increased at most by $15 (50% of $30) for a company electing the profit split option in this example. Although the legislative history of the Act indicates that, under the profit split option, the amount of income allocable to non-possession affiliates is increased by no more than the increase under the Act for companies that elect the cost sharing option,[92] in actual operation, as can be seen by the foregoing example, the increase in the amount of income allocated to non-possession affiliates is greater than under the cost sharing option since the 10% increase in product area research expenditures required by the Act is thereafter multiplied by a fraction, the numerator of which is possessions sales and the denominator of which is total sales, as described in Code §936(h)(5)(C)(i)(I). Although the profit split option may result in a larger portion of R&D expenses being allocated to non-possession affiliates, it still may represent the more attractive alternative, since, under the cost sharing option, there is the overlay of uncertainty produced by the incorporation of the §§482 and 367 requirements, discussed above.

The Act at §1231(f) also makes a technical amendment to §936(h)(5)(C)(ii)(II), relating to the computation of combined taxable income under the profit split method.

In addition to the foregoing, the conferees state that, in cases in which the possession product is leased rather than sold (or is used in the trade or business of a member of an affiliated group) regulations to be issued under §936(h)(7) can permit the use of the cost sharing and profit split methods, but only if (1) an independent sales price can be determined for the product from comparable uncontrolled transactions, and (2) the appropriate member of the group agrees to be treated as having sold the possession product at such price. The conferees further state that they intend that an exception to the first requirement will be provided under conditions deemed appropriate by the Secretary, which may restrict relief to situations where (1) the cost sharing payment is no less than 100% of the product area research cost incurred by the affiliated group, and (2) the deemed sale of the possession product units is treated as made at a price which produced a profit to the appropriate member of the group equal to the possessions corporation's tax-exempt profit with respect to the same units (computed without regard to the cost sharing payment), reduced by one-half of the cost sharing payment allocable to such units.[93]

C. Receipt of Income Within the United States

Section 1231(b) of the Act amends §936(b) to provide that the §936 credit is not denied with respect to otherwise eligible active business income solely by reason of its receipt in the United States where such income is received from an unrelated party. However, present law is retained for investment income (QPSII) and for business income received from related parties.

D. QPSII Redefined

Section 1231(c) of the Act amends §936(d) by adding a new paragraph 4 entitled "Investment in Qualified Caribbean Basin Countries" which expands the categories of qualified possession source investment income (QPSII) eligible for the credit. Under this change, QPSII includes interest attributable to loans made by the Government Development Bank of Puerto Rico (GBD) and other financial institutions for investments in development projects and active business assets located in qualified Caribbean Basin initiative (CBI) countries. Although not defined in the statute, the Senate Report indicates that "development project" generally means an infrastructure investment such as a road or water treatment facility that directly supports industrial development, while "active business assets" generally means plant, equipment and inventory associated with the manufacturing operation.[94] Qualified CBI countries include any "beneficiary" country within the meaning of §212(a)(1)(A) of the Caribbean Basin Economic Recovery Act.[95] However, a CBI country may not be qualified unless there is in effect between that country and the United States an agreement providing for the exchange of information between the United States and such country and there is *not* in effect a finding by the Secretary that the tax laws of such country discriminate against conventions held in the United States.[96]

In addition, the investment must be made in accordance with a specific authorization by the GBD pursuant to regulations to be issued by the Secretary of the Treasury of Puerto Rico.[97] The person in whose trade or business the investment is made and the financial institution also must certify to the Secretaries of the Treasuries of the United

[91] *See* H.R. Rep. No. 841, 99th Cong., 2d Sess. II-634 (1986) (hereinafter "Committee Report").

[92] *See* House Report, 418, and Senate Report, 383.

[93] *See* Committee Report, II-634.

[94] Senate Report, 384.

[95] *See* 19 USCA §2702(a) and (b) (1986 Supp.). These include Anguilla, Antigua and Barbuda, the Bahamas, Barbados, Belize, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Panama, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, Cayman Islands, Montserrat, Netherlands Antilles, St. Christopher-Nevis, Turks and Caicos Islands, and British Virgin Islands.

[96] Code §§936(d)(4)(B) and 274(h)(6)(A).

[97] Code §936(d)(4)(A)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

States and Puerto Rico that the proceeds of the loan will be promptly used to acquire active business assets or to make other authorized expenditures and must permit the examination of their books and records by the Secretaries of the Treasuries of the United States and Puerto Rico as necessary to ensure compliance with the requirements of §936(d)(4).[98]

E. Modification to Gross Income Test

Section 1231(d) of the Act amends §936(a)(2)(B) by increasing the percentage of gross income of the possessions corporation which must be derived from the active conduct of a trade or business from 65 to 75%. This change accords with the general intent of the Act to ensure that a significant portion of the income eligible for the possession tax credit is generated from active investments.[99] However, since the amendments to §936 are effective generally for taxable years beginning after December 31, 1986, and since the 75% figure is computed by reference to a three-year average, the amount of income attributable to the active conduct of a trade or business in the first two taxable years beginning after 1986 may in fact have to be higher than 75%. Unlike the TEFRA amendments, which raised the active trade or business percentage from 50 to 65% over a three-year period, no transition rule appears in the TRA 86 amendments.

[98] TRA §936(d)(4)(C)(i) and (ii).
[99] Senate Report, 383.

IV. Effective Dates

In general, the amendments made to §936 are effective for taxable years beginning after December 31, 1986. The Act, however, provides a special rule applicable to the transfer of intangibles under §936(h)(5)(C) (cost sharing option) pursuant to which the requirement that income with respect to the transfer must be commensurate with the income attributable to the intangible will apply for taxable years beginning after 1986, without regard to when the transfer was made.[100]

In addition, the Act contains a special transition rule for possessions corporations which produced an end product form in Puerto Rico on or before September 3, 1982 and began manufacturing a component of such product in Puerto Rico in its taxable year beginning in 1983 and with respect to which Puerto Rican tax exemption was granted on June 27, 1983. Such corporations, believed to be restricted to Eli Lilly and Company, may treat such components as a separate product for such taxable year for purposes of determining whether such corporation had a significant business presence in Puerto Rico with respect to such product and the income with respect to such product.[101]

[100] Act §1231(g)(2)(B). Transfers made to foreign corporations under §367 and transfers to which §482 (relating to allocation of income and deductions among taxpayers) applies are subject to the new rules with respect to transfers of intangibles only with respect to transfers after November 16, 1985 or licenses granted after such date. Act §1231(g)(2)(A).
[101] Act §1231(g)(4).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 67

DEDUCTIONS FOR DIVIDENDS RECEIVED FROM FOREIGN CORPORATIONS

John P. Warner, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

Prior to the 1986 TRA, U.S. corporate shareholders were not entitled to a dividends received deduction for any dividend paid by a foreign corporation unless the foreign corporation (1) were subject to federal income tax, (2) had engaged in a U.S. trade or business for at least 36 consecutive months prior to the end of the taxable year during which the dividend was paid (or, if shorter, for its entire existence), and (3) received at least 50% of its gross income from income effectively connected with its U.S. trade or business during such 36 month period. The amount of such dividends to which the 85% or 100% dividends received deduction applied was proportional to the portion of the foreign corporation's gross income during the period in which it engaged in a U.S. trade or business that was effectively connected to such trade or business.[1]

Although this system avoided substantial double corporate level taxation of U.S. earnings of certain foreign corporations having substantial U.S. operations when those earnings were repatriated to U.S. corporate shareholders, the system arbitrarily disfavored U.S. earnings of foreign corporations which did not meet the 50% U.S. trade or business test. In such a case, no dividends received deduction was available even with respect to the proportionate amount of dividends attributable to income effectively connected with the U.S. trade or business.

Example: Corporation X, a U.S. corporation, owned all of the stock of Corporation FS, a foreign corporation with U.S. and foreign operations. For each of its taxable years 1980 through 1982, Corporation FS earned $250 in world-wide gross income, $150 of which was derived from foreign businesses and $100 of which was derived from U.S businesses. For its 1982 taxable year, Corporation FS generated $50 of income effectively connected with its U.S. businesses, which income was subject to a U.S. tax (assuming for simplicity a 46% tax rate) of $23 (and no foreign income tax); and foreign source income not effectively connected with a U.S. business of $75, on which $34.50 of foreign income taxes were paid. In 1982, Corporation FS distributed to Corporation X as a dividend an amount equal to $67.50, all of its earnings and profits arising in 1982. Because less than one-half of Corporation FS's gross income for the years 1980 through 1982 was effectively connected with its U.S. business, Corporation X was not entitled to a dividends received deduction even with respect to the $27 in 1982 earnings and profits attributable to Corporation FS's 1982 income that had been subject to U.S. tax. Because Corporation X received as a dividend all of the 1982 earnings and profits of Corporation FS, Corporation X would, for foreign tax credit purposes, be deemed under §902 to have paid the $34.50 in foreign income taxes that Corporation FS paid on its 1982 earnings. For §904 purposes, all $67.50 (plus the $34.50 of foreign income taxes deemed to be paid by Corporation X under §78) of the dividend would be treated as foreign source income.[2] Thus, Corporation X would compute its U.S. tax liability in respect of the dividend based on $102 of gross income, resulting in a tentative U.S. tax liability of $46.92. However, because all of the dividend was treated as from foreign sources, all $34.50 in foreign income taxes deemed paid by Corporation X would be eligible for the foreign tax credit. Thus, total U.S. and foreign taxes on the $125 pre-tax 1982 earnings of Corporation FS would be $69.92 ($23 plus $34.50 plus $12.42).[3]

If, in the above example, Corporation FS had (i) earned from U.S. sources $150 of its $250 1980 through 1982 gross income; (ii) earned $75 in taxable income in 1982 that was effectively connected with its U.S. businesses and paid $34.50× of U.S. income tax thereon; (iii) earned $50× net income in 1982 before taxes from foreign sources not effectively connected with its U.S. business and paid $23 in foreign income taxes thereon; and (iv) distributed a $67.50 dividend to Corporation X, the following would result: Because more than 50% of Corporation FS's gross income for the years 1980 through 1982 was effectively connected with its U.S. businesses, Corporation X would be eligible for the 85% dividends received deduction under former §245(a) with respect to 60% of the $67.50 dividend actually paid, or $40.50. Thus, its taxable income attributable to the dividend would be $56.08 [($40.50 plus $27 plus $23) less (.85 × $40.50)]. Its tentative U.S. income tax liability at 46% would be $25.80. Under §904 it would have $6.08 ($40.50 minus $34.42) in U.S. source taxable income and $50 of foreign source taxable income and would be

[1] Former Code §245(a).

[2] *See* §861(a)(2)(B).

[3] Corporation X would also have an excess foreign tax credit of $12.42× attributable to such dividends.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

permitted a foreign tax credit of $20.50 ($23 × $50/$56.08). Thus, total U.S. and foreign income taxes on Corporation FS's $125 in pre-tax net income would be $62.80 ($34.50 plus $23 plus $5.30).

Section 1226(a) of the 1986 TRA substantially modifies and expands the scope of the §245(a) deduction for dividends paid by foreign corporations to U.S. corporate shareholders. Revised §245(a) in general permits U.S. corporate shareholders owning at least 10% of the stock value and voting power of a foreign corporation to deduct 80% (and, in some cases, 100%) of the dividends received from foreign corporations to the extent those dividends are attributable to post-1986 income effectively connected with a foreign corporation's U.S. business or to post-1986 dividends paid by 80%-owned U.S. subsidiaries of the dividend paying foreign corporation.[4]

II. Analysis of Revised Section 245(a)

A. Qualified 10% Owned Foreign Corporation

Under revised Code §245(a), not all dividends attributable to U.S. earnings of foreign corporations are eligible for the applicable dividends received deduction. Revised §245(a)(1) specifies that only dividends received from a "qualified 10-percent owned foreign corporation" are so eligible. Revised §245(a)(2) defines the term "qualified 10-percent owned foreign corporation" as any foreign corporation — other than a foreign personal holding company or a passive foreign investment company [5] — at least 10% of the stock value and voting power of which is held by the U.S. corporate shareholder receiving such dividend. Although the statute is not explicit in this regard, it would appear that the stock ownership requirement need be met only on the date that the dividend is received. There are no stock ownership attribution rules. Thus, holdings of less than 10% by each of two or more related U.S. corporations cannot be aggregated to meet the 10% stock voting and value requirement.

B. U.S. Source Portion

Under revised Code §245(a)(1), in order to ensure that only the portion of dividends from foreign corporations attributable to U.S. taxed business earnings are eligible for the deduction, only the U.S. source portion of dividends received from qualified 10% owned foreign corporations is eligible for the dividends received deduction. Revised §245(a)(3) defines the term "U.S. source portion" as the ratio of the dividend payor's "post-1986 undistributed U.S. earnings" to its "total post-1986 undistributed earnings." Essentially, in computing this ratio, the foreign corporation's earnings and profits, computed in accordance with §§964 and 986 principles, arising in taxable years beginning after 1986 that were not distributed prior to the taxable year at issue must be computed.[6]

The U.S. source portion of such total earnings and profits is the portion "attributable to" either (1) income of the dividend payor that was effectively connected with a U.S. business and subject to income tax or (2) dividends received (directly or through a wholly owned foreign corporation) from U.S. corporations at least 80% of the stock value and voting power of which is owned by the dividend payor (directly or through one or more tiers of such wholly-owned foreign subsidiaries).[7]

Computation of the U.S. source portion of a dividend received from a qualified 10% owned foreign corporation is determined on a rolling average basis.[8] (For simplicity, a 46% tax rate is assumed.)

> *Example*: Corporation X owns 20% of the stock of Corporation FS, a foreign corporation, which in its taxable year beginning January 1, 1987, earns (i) $50 in income effectively connected with its U.S. trade or business on which it pays $23 in U.S. income taxes and (ii) $75 in foreign source non-U.S. business income, on which it pays $34.50 in foreign income taxes. Corporation FS's earnings and profits computed under §§964 and 986 principles for 1987 are $67.50, of which $27 is attributable to its U.S. business income. If, on December 31, 1986, Corporation FS pays $50 in dividends to its shareholders, including $10 to Corporation X, the U.S. source portion of the dividends paid to Corporation X would be $4 ($10 × $27/$67.50). (Note that the total U.S. source portion of the $50 distribution was $20, *i.e.*, $50 × $27/$67.50.)

Assume further that during 1988 Corporation FS earns $50 in U.S. business income on which it pays $23 in U.S. income tax, earns $50 in foreign source non U.S. business income on which it pays $23 in foreign income taxes, and has $54 in earnings and profits. If on February 1, 1988, Corporation FS pays $17.50 in dividends, of which Corporation X receives $3.50, the U.S. source portion of the dividend paid to Corporation X would be $1.47 ($3.50 × [($27 - $20) plus $23] divided by ($17.50 plus $54)). Had a last-in, first out method been used, the U.S. source portion of the dividend paid to Corporation X would have been $1.49 [$3.50 × ($23/$54)]. Had a pure first-in, first-out method been used, the U.S. source portion of the dividend paid to Corporation X would have been $1.40 [$3.50 × ($7/$17.50)].

Comment: Even as revised, §245(a) does not permit a dividends received deduction for U.S.-taxed business earnings of lower-tier foreign subsidiaries. §245(a)(5) treats as U.S. earnings eligible for the deduction only the U.S. business income of the qualified 10% owned foreign corpo-

---

[4] §611(a) of the 1986 TRA amends §243(a) to reduce from 85% to 80% the amount of a dividend received by a corporation from an unaffiliated corporation that can be deducted. Code §245(a) incorporates §243(a) by reference.

[5] Code §1296, enacted by §1235(a) of the 1986 TRA, defines a passive foreign investment company as any foreign corporation 75% or more of whose gross income for a given year is passive income within the meaning of §904(d)(2)(A) (*i.e.*, dividends, interest, rents, royalties, annuities and certain other forms of income) or at least 50 % of the value of whose assets is held for the production of such passive income.

[6] Revised Code §245(a)(4), which refers to Code §902(c)(1) for the definition of "total post-1986 undistributed earnings."

[7] Revised Code §245(a)(5). *See also* H.R. Rep. No. 841, 99th Cong., 2d Sess. II-629 (1986).

[8] *See* footnote 6, *supra*. Act §1226(b) amends Code §959(d), which treats non-taxable distributions by controlled foreign corporations of previously taxed income as non-dividend distributions, to provide that such distributions will reduce the distributing corporation's earnings and profits.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ration itself and dividends paid to such corporation (directly or indirectly through wholly owned foreign corporations) by its U.S. — but not its foreign — subsidiaries operating in the U.S.

In determining the portion of a dividend received from a qualified 10% owned foreign corporation by a U.S. corporate shareholder, only those post-1986 earnings and the U.S. source portion thereof arising in the taxable year during which the foreign corporation became a qualified 10% owned foreign corporation with respect to the U.S. corporation shareholder and thereafter are taken into account.[9] Thus, if a U.S. corporation first acquires 10% of the stock value and voting power of a calendar year foreign corporation on July 1, 1988, the foreign corporation's earnings and U.S. source earnings for 1988 and after — but not before — would be relevant in determining the amount of dividends paid to the U.S. corporate shareholder that were eligible for the deduction. As this provision is drafted, it could lead to problems where, during the year of sale but prior to the sale, dividends are paid to those who sell their stock in a foreign corporation to a U.S. corporation which thereby becomes a 10% shareholder.

Example: Corporation FS is a calendar year foreign corporation with U.S. and foreign operations. During 1987, Corporation FS has $500 in total earnings and profits of which $200 represents the U.S. source portion. During 1988, Corporation has $1000 in total earnings and profits of which $500 represents the U.S. source portion. From January 1, 1987 through July 1, 1988, Corporation A, a U.S. corporation, owns 10% of the stock value and voting power of Corporation FS. On February 1, 1988, Corporation A receives a $75 dividend from Corporation FS. On July 1, 1988, Corporation A sells its entire interest in Corporation FS to Corporation B, another U.S. corporation. On December 31, 1988, Corporation FS distributes a $75 dividend to Corporation B. The U.S. source portion of the dividend paid to Corporation A takes into account Corporation FS's 1987 and 1988 earnings, and is thus $35 [$75 × ($700/$1,500)]. The U.S. source portion of the dividend paid to Corporation B takes into account only Corporation FS's 1988 earnings, and is thus $37.50 [$75 × ($500/$1,000)]. However, the combined U.S. source portions of the dividends paid to Corporations A and B — $72.50 — exceeds the 10% of the total $700 U.S. portion of the earnings of Corporation FS from which the dividends were paid.

C. *Coordination with Foreign Tax Credit Rules*

Revised Code §245(a)(8) denies a foreign tax credit for any foreign tax paid by a qualified 10% owned foreign corporation attributable to the U.S. source portion of a dividend to a U.S. corporation. This rule is designed to prevent 10% U.S. corporate shareholders of foreign corporations from getting a double benefit from the U.S. source portion of such dividends. Without this rule, not only would the shareholder receive the dividends received deduction but in addition would be entitled to a foreign tax credit on foreign taxes paid by the qualified 10% owned foreign corporation with respect to the U.S. portion of such dividends because the foreign taxes paid by the qualified 10% owned foreign corporation would be deemed to have been paid by the U.S. corporate shareholder under §902.[10]

Revised Code §245(a)(9) provides that, for purposes of the §904 limit on the amount of foreign taxes for which the foreign tax credit is available, the U.S. source portion of any dividend received from a qualified 10% owned foreign corporation is treated as income from U.S. sources. This in general continues the pre-1986 TRA rule contained in Code §861(a)(2)(B), which treated as U.S. source income 100/85 of the amount of a §245(a) dividends received deduction.

D. *Effective Date*

The rules of revised §245(a) are generally effective with respect to dividends paid by qualified 10% owned foreign corporations out of earnings and profits from all taxable years beginning after 1986. Act §1226(c)(1). As noted earlier, however, only the U.S. source portion of earnings arising during and after the taxable year in which a U.S. corporate shareholder first meets the stock ownership requirements is taken into account in determining the dividends received deduction available to such shareholder.

[9] Revised Code §245(a)(6).

[10] As this provision is drafted, it may have the effect of denying the foreign tax credit otherwise available but still requiring the 10% U.S. corporate shareholder to increase its gross income by the amount of foreign tax attributable to the U.S source portion of the dividend. Revised Code §245(a)(8) does not literally override Code §902(a), which treats a U.S. shareholder as having paid the foreign taxes actually paid by a qualified 10% owned foreign corporation that pays a dividend to it; §245(a)(8) merely disallows a credit for those taxes under Code §901. However, §78 requires a corporation to increase its gross income by the amount of foreign taxes that it is deemed to have paid under §902.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 68

INTERCOMPANY TRANSFER PRICING: INTANGIBLES; IMPORTS

Harrison B. McCawley, Esq.
Silverstein and Mullens
Washington, D.C.

I. Background and Legislative History

This chapter discusses the amendments made by the Tax Reform Act of 1986 [1] to §§367, 482 and 936 of the Code [2] relating to the transfer, sale or licensing of intangible property. The principal focus of this discussion is the amendment made to §482, which is incorporated by reference into the amendments made to §§367 and 936.

A. Background — Transfer Pricing Theories under §482

To obtain proper perspective on the implications of the amendment to §482 it is necessary first to go into the background of the statute at some length.

Section 482, which has appeared substantially in its present form in U.S. internal revenue laws for more than 50 years, provides the Commissioner authority to "distribute, apportion, or allocate" items of gross income, deductions, credits, or allowances between or among commonly controlled organizations, trades or businesses when deemed necessary to prevent the evasion of taxes or clearly to reflect their income. Its legislative history suggests that the principal purpose for its enactment was to prevent tax evasion by U.S. taxpayers by effectively shifting income earned or generated by their activities in the U.S. to foreign jurisdictions. The foreign sales company appears to have been the principal tax avoidance model: the selling of property produced or purchased in the U.S. to a foreign sales subsidiary for a price which would enable the subsidiary to garner a disproportionate share of the combined net profit from the production and sale of the property in question. The reach of the statute is extremely broad. It has long been well settled that no intent to avoid tax or distort income need be established as a basis for its application. It applies not only to sales of property but to low interest loans, the rendition of services, and the use of property, both tangible and intangible. In the period prior to World War II, the statute was interpreted, generally, and in accordance with the implication of its operative terms, to authorize, at the Commissioner's discretion, the allocation among the members of a commonly controlled group (most often a parent and subsidiary or two sister corporations) the net income (or loss) realized by the group for a taxable year in transactions with persons outside the group.[3] It was also applied to allocate an item of loss or deductible expense from the member claiming it to the member which the Commissioner determined had actually benefitted from the expense involved or had actually sustained the loss claimed. In other words, for an allocation to be made, there had to be either a quantum of group net income or an item of expense or loss to be allocated. The general rule was that where no income had been realized, there was nothing to allocate.[4]

1. The Unitary Approach

As the taxation of U.S. persons carrying on foreign operations came increasingly under scrutiny after the war, it was perceived that numerous long tolerated abuses were seriously eroding the U.S. tax base. Among these was intercompany transfer pricing of the kind §482 could prevent if properly enforced. Enforcement, however, posed a number of difficulties of a conceptual or theoretical kind. The policing of transfer pricing involves two distinct and opposed approaches, often termed "unitary" and "separate entity." The unitary approach reflects the general interpretation of the statute described above. Under it, the members of the commonly controlled group are viewed as an economic unit; transfer pricing should result in an allocation of the unit's net profit (or loss) for a given taxable period among the members in accordance with their respective economic contributions or activities. In the case of the manufacturer of goods and its foreign sales subsidiary, the apportionment of the net income is based on such economic factors as capital invested, the degree of sales activity, risks incurred, and the like. Many states have adopted a version of this approach in determining the portion of a multistate or multinational entity's total profits attributable to its activities within the state, using a formula giving each relevant economic factor a fixed weight. This method sometimes referred to as "formulary apportionment." In applying §482 under the unitary approach, however, the weighting of economic factors is based on facts and circumstances.

This unitary approach was found unsatisfactory for a number of reasons. Essentially it calls for the determination

[1] P.L. 99-514, approved by the President October 22, 1986, hereinafter referred to as the Act or 1986 TRA.

[2] "Section" as used herein refers to sections of the 1954 Internal Revenue Code as in effect before the enactment of P.L. 99-514 or to sections of the 1986 Internal Revenue Code, the official designation of the Code as revised by the Act, depending on the context in which used. *See* §2 of P.L. 99-514.

[3] On occasion, allocation was also made of gain or loss realized in inter-member transactions where one of the members was subject to a foreign tax jurisdiction. *See Asiatic Petroleum Corp. v. Comr.*, 79 F.2d 234 (2d Cir. 1935), cert. denied, 296 U.S. 645 (1935).

[4] *See Asiatic Petroleum v. Comr., supra.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

of a reasonable profit split between or among entities which are often engaged in extremely complex transactions. What apportionment of profit is "reasonable" was deemed too vague a criterion for the application of tax laws. Formulary methods were believed unsatisfactory because they failed to take into consideration the sometimes substantially different factors affecting different kinds of businesses and economic factors in different parts of the world. Another defect was that in many instances, intercompany transactions often involved only one or a small group of items. To apply the unitary method, the net profit or loss from the transaction(s) in question had to be traced. In the case of an interest-free loan, for example, it was virtually impossible to attribute a given quantum of the borrower's profits to the use of the funds. Again, where property was sold for a bargain price, no allocation was possible until it had been resold or placed in service by the purchaser to generate income or deductions. This might involve the allocation of income or loss realized or sustained in one or more taxable years to a different year than the year of the transaction giving rise to the adjustment. This involved difficulties with the annual accounting period basis for determining taxable income.

2. The Separate Entity Approach

In the early 1960's, the Treasury Department, having decided to launch an international enforcement program based on vastly increased use of of §482 to police transfer pricing of all kinds, was persuaded that while the unitary approach need not be abandoned altogether, the separate entity or arm's length method promised a much more effective and easily administered set of principles for carrying out the intent of §482. This approach assume that for each intercompany transaction, one can usually determine the terms to which unrelated persons, dealing at arm's length, would have agreed in entering into an identical or closely similar transaction. In the case of a loan, one need only consult the market interest rates prevailing at the time of the loan. In the case of the sale of goods, it was assumed that on the basis of sales of the same or similar goods to unrelated persons, or from other data available to the IRS, a "comparable uncontrolled price" could be determined. Once the appropriate arm's length price applicable to a given transaction had been determined, the §482 adjustment called for was to increase the taxpayer's income (and correlatively to decrease the other controlled person's income) in an amount equal to the difference between the transfer price actually charged and the arm's length price. This method had the virtue of applying objective standards in lieu of the vague reasonable profit split standard. It eliminated tracing. This method was embodied in Regs. §1.482-2 and, with the one exception noted below, *must* be applied by the IRS in making allocations under §482, subject to certain "safe haven" deemed arm's length prices or charges.

3. IRS Practice

While the IRS continues to use the term "allocation" to describe adjustments under the separate entity method, no allocation (or apportionment or distribution) is actually involved. The adjustment is made whether or not any profit or loss, net or gross, is realized by the group or by either party to the transaction. While the Tax Court initially resisted this interpretation of the statute, the IRS eventually prevailed in the courts of appeal, and there is no longer any serious question as to the validity of arm's length or separate entity "allocations" under §482.

The regulations referred to do not, however, completely abandon the unitary method. In certain circumstances, where comparable uncontrolled transaction data are impossible to obtain, Regs. §1.482-2(e) permits use of a "fourth method," which is generally understood to permit what are essentially unitary method allocations.[5] Over the years, however, the IRS has found that, with a few exceptions, the determination of appropriate arm's length prices based on a comparable uncontrolled transactions is vastly more difficult than had been assumed. Resort to the the fourth method, therefore, despite regulations elaborating in fine detail the arm's length rules, is applied with increasing frequency and has on numerous occasions been upheld by the courts as a valid application of the statute.

B. Transfers of Intangible Property: Prior Law

The transfer of intangible property, typically patent rights, trade secrets, trademarks, and the like, by a U.S. taxpayer who has developed or otherwise acquired the property to a related foreign entity has long been a cause of concern to the IRS. Such transfers can be effected in three different ways, each of which, prior to the 1986 TRA amendments, had different tax consequences. The transfer could be in the form of a license, usually calling for the payment of royalties by the transferee. It could be in the form of a sale of all the substantial rights of the owner, either for a lump sum amount or for an amount contingent on the income derived by the transferee from the exploitation or use of the intangible property. Lastly, the transfer could take the form of a contribution to the capital of a controlled corporation which, under §351, is accorded nonrecognition of gain or loss, or, more rarely, there could be a nonrecognition transfer within the provisions of §361 as part of a reorganization.

1. Section 482

In the case of a license or a sale, Regs. §1.482-2(d), relating to the transfer or use of intangible property, was applied. The regulations authorize appropriate allocations where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities to another for other than an arm's length consideration. Despite certain language seemingly to the contrary in *Eli Lilly & Co. v. Comr.*,[6] it seems clear that these regulations have no application to a §351 transfer since, in this context, arm's length consideration is irrelevant.

Intangible property is defined to consist of the following items, provided they have substantial value independent of the services of individual persons:

(a) Patents, inventions, formulas, processes, designs, patterns and other similar items;

(b) Copyrights, literary, musical or artistic compositions, and other similar items;

[5] *See, e.g., DuPont v. U.S.*, 608 F.2d 445 (Ct. Cl. 1979), cert. denied, 100 S. Ct. 1648 (1980).

[6] 84 T.C. 996, 1128-29 (1985).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(c) Trademarks, trade names, brand names and other similar items;

(d) Franchises, licenses, contracts and other similar items;

(e) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data and other similar items.[7]

The regulations adopt, as do the other sections of Regs. §1.482-2, the position that arm's length consideration is to be determined on the basis of comparable uncontrolled transactions entered into either by the taxpayer or by another similarly situated transferor. Where a sufficiently similar transaction involving an unrelated party cannot be found, Regs. §1.482-2(d)(2)(iii) lists 13 factors which should be considered in arriving at an approximation to an arm's length price.

Note: These regulations would, by implication, seem to rule out resort to a "fourth method" or profit split approach, in view of these elaborate instructions for the determination of arm's length consideration. That is, the absence of comparable uncontrolled transaction data does not authorize proceeding immediately to basing of an allocation on the profit split or other unitary methods. The factors enumerated, some of which will always be quantifiable to a degree, must be applied to arrive at a hypothetical uncontrolled price. Note that in *Lilly*, *supra*, where the court agreed that a profit split approach was authorized under the regulations and case law, the §482 adjustments involved were based on Regs.§1.482-2(e) (sales of tangible property) rather than on §1.482-2(d). The possessions affiliate was determined by the IRS to have been a contract manufacturer which overcharged its U.S. parent for the goods manufactured using the parent's intangibles and sold to the latter.

The Ways and Means Committee report [8] expresses concern that §482 may not be operating to assure adequate allocations of income to U.S. taxpayers who transfer intangibles to related foreign entities. The report notes that "Many observers have questioned the effectiveness of the 'arm's length' approach of the regulations under §482," and identifies as a recurring problem the absence of comparables.

The problem is particularly acute, according to the report,[9] where the intangible transferred has a high profit potential.

Comment: Aside from the technical difficulties in applying the separate entity approach to transfers or licenses of intangible property, while not emphasized in the report, one factor apparently underlying the IRS's continuing concern with this area is that since the research and development costs associated with any intangible are usually deducted currently under §174 by the U.S. developer, the U.S. should at the least be entitled to "recapture" these deductions as the intangible generates income, irrespective of the technicalities of ownership. It is submitted that a far greater concern was the fact that intangibles, arguably the country's principal industrial assets, create not only tax revenue but jobs and export income, all objects of past and current tax laws. The transfer abroad of intangibles results in a permanent loss of these valuable elements of the economy. While the committee reports do not clearly articulate this, some radical disincentive to such transfer would seem to have been contemplated by Congress.

The report refers to *United States Steel Corporation v. Comr.*,[10] a case in which the Second Circuit ruled that an arm's-length charge for the transportation to the taxpayer's domestic facilities from South American mining sites of iron ore on vessels owned by its subsidiary was sufficiently established to prevail over a profit split allocation made by the Tax Court, where the charges relied on for this purpose related to certain transportation furnished to an unrelated entity making up only a very small (less than 5%) portion of the subsidiary's operations. The Committee expressed concern that "such decisions may unduly emphasize the concept of comparables even in situations involving highly standardized commodities or services," [11] a somewhat surprising statement in view of the above cited regulations of long standing requiring allocations to be made on the basis of arm's length pricing determined by reference to comparable uncontrolled transactions or an approximation thereof.

2. Sections 367 and 936

Another Code provision affecting the tax consequences of transfers of intangibles by U.S. persons to foreign entities is §367(d), enacted by P.L. 98-369 (Tax Reform Act of 1984). Prior to enactment of §367(d), §351 applied to confer nonrecognition of gain where intangibles were transferred by a U.S. parent to its foreign subsidiary as a contribution to capital where the intangibles were to be used by the subsidiary in the active conduct of a trade or business and where they were not to be used in a U.S. trade or business or for manufacturing products to be sold or consumed in the U.S.[12] In such a case, the foreign corporation would be recognized as a corporation under §367 (and, hence, the provisions of §351 applied) since the transfer would not be deemed to have as a principal purpose the avoidance of U.S. tax.

Section 367(d) provides that, except as provided by regulations, if a U.S. person transfers intangible property to a foreign corporation in an exchange described in §§351 or 361, the transfer is treated as a sale in exchange for payments over the useful life of the intangible made on an annual basis reflecting the amounts that would have been received under an agreement providing for payments contingent on use, productivity, or disposition of the property.[13] Amounts included in income under these provisions are treated as ordinary income; the transferee is entitled to deduct the same from earnings and profits.

The intangibles subject to these rules are intangible property within the meaning of §936(h)(3)(B). The items

[7] Regs. §1.482-2(d)(3)(ii)(a) through (e).

[8] H.R. Rep. No. 426, 99th Cong., 2d Sess. at 423 (1986). There was no similar provision in the Finance Committee bill. This report is be referred to hereinafter as "H.R. Rep."

[9] H. R. Rep. at 424.

[10] 617 F.2d 942 (2d Cir. 1980).

[11] *Id.*

[12] *See* Rev. Proc. 68-23, 1968-1 C.B. 821.

[13] §367(d)(2)(A), as in effect prior to enactment of the Act.

enumerated in that subparagraph are essentially the same items as those enumerated in Regs. §1.482-2(d)(3)(ii)(a) through (e) set forth above.

These rules are to have no application in a case where the IRS determines that an adjustment under §482 is appropriate because the foreign transferee obtained the use of the property without sufficient compensation. Further, §367(d) is to have no application to bona fide cost sharing arrangements described in Regs. §1.482-2(d)(4), as amplified by any elaborations Treasury deems appropriate. The House committee report cited above also noted that these special §367 rules were not completely adequate to deal with the problem of tax avoidance and/or U.S. revenue loss stemming from transfers of intangibles.

Finally, transfers of intangibles to U.S. possessions corporations are subject to special rules by §936. Since these are U.S. corporations, §367 does not apply to the transfers. As noted in the House report, it was unclear how transfers of intangibles to possessions corporations as contributions to capital (the usual form of transfer) should be treated. The *Lilly* case, cited above, involved such a typical transfer. The years involved were all prior to 1982. The offshore affiliate received the parent's manufacturing intangibles, manufactured the products and sold them to the parent for resale to its customers under its trade name. Thus, the marketing intangibles were retained by the parent/transferor. In *Lilly*, the IRS took the position (also typical in such situations) that despite the form of the transfer, the possessions corporation was merely a contract manufacturer, and that all of its income, less an allowance for its manufacturing expenses plus a reasonable mark-up, should be treated as earned by the parent. The court, while rejecting this position, on the ground that the IRS was bound by §351 and must recognize ownership of the transferred intangible by the transferee, nevertheless allocated to the parent an amount of the subsidiary's profits equal to what it considered would have been demanded as contributions to the parent's ongoing basic research and development expenses from an unrelated transferee or licensee of the intangibles, a decision somewhat difficult to square with the §482 regulations. In effect, despite the rationale given for the holding, the court would appear to have arrived at what was basically a profit split application of the statute, based on its view of the related members' economic contributions to the net combined profits of both.

In 1982, §936 was amended to provide specific rules for the allocation of intangibles income between a U.S. parent and its possessions subsidiary in cases of the *Lilly* type. Generally, all income attributable to the transferred manufacturing intangibles is allocated to the parent transferor unless one of two specified options is elected. Under the first, the cost sharing option, the possessions corporation is treated as the earner of the income attributable to manufacturing intangibles (but not, generally, marketing intangibles) provided it makes payments to the parent of a portion of the latter's research and development costs under a formula provided in the statute. Under the second, the parties may elect a 50/50 profit split. However, §482 may still be applied to the transfer prices charged by the subsidiary in sales to the parent where they are not arm's length. Section 482 may also be applied to allocate income attributable to marketing intangibles.

Congress felt that neither §367 nor §936 provided significantly better protection that did §482 against revenue loss from the shifting of income through transfers of intangibles, especially those with high profit potential, to foreign (or possessions) entities.

C. The House Bill

Section 641 of The Ways and Means Committee's bill amended both §936 and 367.

Under the amendments to §936, the cost sharing payment required for companies electing the cost sharing option (with respect to intangibles the possessions corporation was treated as owning) was revised to an amount equal to 110% of the amount required under prior law or, if greater, the royalty payment that would be due under §367 as modified by the Act.

The amendment to §367 was to add to §367(d)(2)(A) (discussed above) the provision that amounts taken into account under clause (ii) shall be "commensurate with the income attributable to the intangible." Further, in the case of any transfer in a transaction not qualifying under §351 or §361 to a foreign entity (*e.g.*, a transfer by a corporation to a commonly controlled sister corporation), rules similar to these rules are to be applied for purposes of §482. The House report states that its approach applies both with respect to outright transfers of ownership of the intangibles (whether by sale, contribution to capital or otherwise) and licenses or other arrangements for the use of intangibles.[14]

The House bill did not apply to inbound transfers. It, therefore, contained no provisions applicable to the amount deductible as royalty expenses by a U.S. corporation to which intangibles had been transferred by a foreign entity, or the amount includible in such foreign entity's taxable income as computed under U.S. tax principles (where applicable).

The Senate bill contained no provisions relating to the transfer of intangibles to foreign entities.

II. Overview

Section 1231(e)(1) of the Act amends §482 by adding an additional sentence: "In the case of any transfer (or license) of intangible property (within the meaning of §936(h)(3) (B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

Section 1231(e)(2) of the Act amends §367(d)(2) by adding at the end a new sentence: "The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible."

Section 1231(a)(1) of the Act amends §936(h)(5)(C)(i) (I) to provide that if an election is made under the cost sharing option, the amount payable by the transferee of the intangibles (the possessions corporation) of product area research of the group is not to be less than 110% of its proportionate share based on the ratio of

[14] H. R. Rep. at 425.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

possessions sales to total sales of the group. In other words, prior law is retained except for the addition of the 110% factor. However, the subclause is further amended to provide that, in the case of intangibles described in subsection (h)(3)(B)(i) which the electing corporation is treated as owning under subclause II, the payment required is not to be less than the inclusion or payment that would be required under §367(d) (2)(A)(ii) or §482 if the corporation were a foreign corporation.

Thus, the standard "commensurate with the income attributable to the intangible" is applied under all three of these amended Code sections.

The amendments made by Act §1231(e) apply to taxable years beginning after December 31, 1986, but only with respect to transfers after November 16, 1985 or licenses granted after that date (or before such date with respect to property not in existence or owned by the taxpayer on such date).[15]

For purposes of §936(h)(5)(C), the amendments made by Act §1231(e) apply to taxable years beginning after December 31, 1986 without regard to when the transfer (or license) was made.[16]

In addition, a technical correction of the profit split rules of §936(h)(5)(C)(ii)(II), applicable to taxable years after December 31, 1982,[17] strikes out "all products produced and types of services rendered" and replaces these words by "all products and types of services, within such product area, produced or rendered." [18]

In many instances, U.S, importers of goods claim transfer prices exceeding the amounts claimed in customs declarations. Congress concluded that where a U.S. taxpayer imports property in a transaction with a related person, the basis or inventory cost of such property should not exceed the value placed on the property for customs purposes as a general rule. This matter is separate and distinct from the problems involving intangibles discussed above. Act §1248 adds §1059A to the Code, providing that where property is imported into the United States in a transaction (directly or indirectly) between related persons (within the meaning of §482), the amount of any costs taken into account in determining basis by the purchaser which are also taken into account in computing the customs value of the property are not to exceed such latter costs. "Customs value" means the value taken into account in determining any duties imposed on the importation of property. "Import" means the entering or withdrawal from a warehouse for consumption, except as may otherwise be provided by regulations.

These provisions apply to transactions entered into after March 18, 1986.[19] Comments on §1059A are provided in III, F, below.

[15] Act §1231(g)(2)(A).
[16] Act §1231(g)(2)(B).
[17] Act §1231(g)(3).
[18] Act §1231(f).
[19] Act §1248(c).

III. Detailed Analysis of Provisions Concerning Transfers of Intangibles

A. General Observations

In the simplest terms, the amendment to §482 (and, by implication, the amendments to §§367 and 936) adopt the "profit split" approach to the allocation of income attributable to intangibles, whether transferred in a nonrecognition transaction, by sale, or used by a commonly controlled entity under a licensing agreement. In addition, the provisions, as the Conference Committee report makes clear, are to apply to all transfers or licenses between commonly controlled entities irrespective of whether the transferee/licensee is a U.S. or a foreign entity.[20]

One major change from the previous rules under §§482 and 367 is the so-called "second look" rule. Under prior law, if the royalties payable (or payments of the sale price based on income derived from the intangibles) constituted an arm's length charge at the time the licensing or sale agreement was entered into, then, unless the agreement provided for revision by either or both parties (options to terminate on notice, for example) at some specified period(s) prior to the end of the payout or royalty term, no adjustment was permissible based on subsequent changes in circumstances.[21] Under the language of the amendment, the House report states that: "the inquiry as to appropriate compensation for the intangible [is not] limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The committee intends that consideration also be given the actual profit experience realized as a consequence of the transfer. Thus, the committee intends to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible." [22] The report indicates that the income attributable to the intangibles is to be reviewed on an annual basis, and, if there are "major variations" in the facts and circumstances, the formula or basis for allocating income attributable to the intangibles may also be changed.[23] This applies irrespective of whether the licensing agreement provides for termination at the option of either party. Two questions are left unanswered: (1) what is meant by "major variation?"; (2) do these comments contemplate retroactive adjustments?

The Conference Committee concedes that "many important and difficult issues under section 482 are left

[20] Conf. Rep. No. 841, 99th Cong., 2d Sess. (hereinafter referred to as "Conf. Rep.") at II-637: "The concerns addressed in the House bill originated in connection with transfers of intangibles from U.S. parties to foreign affiliates, particularly those operating in low-tax foreign countries. Consequently, the provisions of the House bill only were applied to transfers of intangibles from U.S. persons to their foreign affiliates. In view of the fact that the objectives of these provisions — that the division of income between related parties reasonably reflect the relative economic activity undertaken by each — applies equally to inbound transfers, the conferees concluded that it would be appropriate for these principles to apply to transfers between related parties generally if income must otherwise be taken into account." The language "reflect the economic activity undertaken by each" is a pure expression of the unitary method discussed above.
[21] *See, e.g. French v. Comr.*, 60 T.C. 836 (1973).
[22] H. R. Rep. at 425.
[23] *See* H. R. Rep. at 425-426.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

unresolved." It is recommended that the IRS conduct a study of the intercompany pricing rules and that careful consideration should be given to whether existing regulations should be modified in any respect.[24]

Comment: Obviously, the amendment to §482 invalidates most of Regs. §1.482-2(d), requiring allocations based on the use of intangibles to be based on comparable uncontrolled transactions. These regulations will obviously have to be rewritten. The language in the committee report cited would thus appear, by implication, to contemplate a reconsideration of the arm's length standard approach under *other* subsections of Regs. §1.482-2 as well. If, as some commentators seem to feel, the unitary or profit split method for applying §482 should be given official recognition (other than the brief and somewhat restricted authority to resort to a "fourth method" in Regs. §1.482-2(e)), the federal transfer pricing rules may move closer to the state unitary methods which, up until the present time, the federal authorities have attempted to persuade the states to abandon.

B. *What Does "Commensurate With the Income Attributable to the Intangible" Mean?*

The words, "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible," read without the background of the regulations under §482 and the many cases involving their application to concrete fact patterns, conveys a somewhat vague principle. The House report, commenting on this language, declares that it does not mandate the use of the "contract manufacturer" or "cost plus" methods of allocating income, or of any other particular method.[25] Thus, presumably, the "developer" (to use the term employed in Regs. §1.482-2(e)) of the intangible will not necessarily be deemed to have earned *all* of the income attributable to its use, leaving to the user only a reasonable profit margin on its manufacturing expenses.[26] The House report suggests as factors to be considered in applying the new profit split rule are "the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible, or, instead, sells products produced with the intangible largely to related persons (which may involve little sales risk or activity) and has a market essentially dependent on, or assured by, such related parties' marketing efforts."

The report emphasizes, however, that primary weight is to be given "the profit or income stream generated by or associated with intangible property."[27] Risks and sales efforts have often been weighed in determining arm's length prices, not only for the use or transfer of intangible property, but also for services and, most often, for the sales of goods. The methods used in applying the separate entity or arm's length approach and the unitary or profit split approach overlap to a considerable extent, a fact that has caused much confusion in the courts and on the part of IRS examiners attempting to follow the regulations. The one important difference under the revised statutory language is that the "functional analysis" will no longer be undertaken to determine an arm's length price, as seems to be its principal purpose in IRM 42(33)-1, but to match profit sharing with "economic activity."

C. *Cost Sharing*

The Conference Report[28] emphasizes that there is no intention of precluding "the use of certain bona fide research and development cost sharing arrangements as an appropriate method of allocating income" where consistent with the purposes of the provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. The report further states that the cost sharer would be expected to bear its share of such R&D costs "on unsuccessful as well as successful products within an appropriate product area,[29] and the costs of research and development at all relevant development states would be included."

It is contemplated that, consistent with the language of the amendment, "the allocation of R&D cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development." This language reflects the suggestion for the Joint Committee's problem regarding the potential for "cherrypicking forwarded to Treasury officials by a law firm.[30] The term "cherrypicking" means contributions by the foreign user of the intangibles to selected potentially highly profitable research and development projects only. If costs are shared proportionate to gross profits (rather than gross sales as under §936(h)(5)(C)(i) and under proposed Regs. §1.482-2(d) issued in 1966), the cost sharer must assume the same risks as the developer within the product area. This is reinforced by the requirement that the costs of both unsuccessful as well as successful research projects must be shared.

Comment: A more precise definition of "product area" and details regarding cost sharing principles will have to be provided by regulations. One problem which will have to be faced, however, is the extent to which cost sharing payments qualify as deductible expenses under the tax laws of the foreign country in which the subsidiary carries on its operations. Royalty payments are closely scrutinized by foreign tax authorities as potential devices for the distribution of dividends.

---

[24] Conf. Rep. at II-638.

[25] H. R. Rep. at 426. Of course, if the user of the intangibles is, in fact, a contract manufacturer, the normal §482 methods, following Regs. §1.482-2(b), based on arm's length charges for the services rendered will, presumably, apply.

[26] This "contract manufacturer" approach was the basis for the §482 adjustments in *Lilly*, supra. Tax Management understands that this approach is often employed by IRS international examiners despite the mandate of Regs. §1.482-2(d) that comparable uncontrolled transaction data be used wherever feasible. Under these regulations, any allocation must be based on the hypothetical charge that would have been made in an uncontrolled transaction. The "cost plus" method is just a variation of this; it allocates to the user a mark up on costs incurred to the exclusion of any of the profit attributable to the use of the intangible.

[27] *Id.*

[28] All references to the Conference Report in the discussion of cost sharing are to Conf. Rep. at II-638.

[29] Presumably, but perhaps not necessarily, the three digit Standard Industry Classification categories used for §936 cost sharing purposes; this will be clarified in the regulations.

[30] Letter to Stephen Shay, International Tax Counsel from Philip D. Morrison of Ivins, Philips and Barker reprinted in Tax Notes Today, October 10, 1986, at T-17.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The risk factor is made clear by the Committee's comment that to the extent that one party contributes funds toward R&D at a significantly earlier time than another, or is putting its funds at risk to a greater extent than another, "it would be expected that an appropriate return would be required to such party to reflect its investment."

Cost sharing arrangements established under Regs. §1.482-2(d)(4) will have to be reviewed and, where necessary, amended in the light of the Committee's comments.

D. Double Taxation Problems

One problem that looms on the horizon in taxable years after 1986 is the reaction of foreign tax authorities to deductions claimed by affiliates of U.S. taxpayers based on the amendments hereunder discussed. Most of our major trading partners are members of the OECD [31] whose Committee on Fiscal Affairs issued a report in 1979 [32] taking unequivocally the position that adjustments to transfer prices made by the member states should be based on the separate entity or arm's length method. The unitary method is viewed in the report as, generally, unacceptable except as a reference point to test the reasonableness of the arm's length prices determined, or, alternatively, as an aid in determining arm's length prices. While not binding on any member state, the report is well known to tax officials involved in transfer pricing disputes, notably the competent authorities charged with carrying out the mutual agreement procedures of the various tax treaties to which the U.S. is a party.

Where an allocation is made by the U.S. exceeding what would be an arm's length royalty charge under OECD and former §482 principles, foreign tax authorities may be expected to refuse, categorically, to grant a correlative adjustment to the foreign entity. Further, it is unrealistic to expect that the IRS can persuade foreign tax authorities, in competent authority proceedings, to grant even partial correlative adjustment relief in such cases. Should a §482 adjustment (or an adjustment under §367(d)) be made increasing the gross income of a U.S. taxpayer, economic double taxation will result. Due, in part, to the lowering of U.S. tax rates and tightening, generally, of the limitations provisions of §904 by the Act (*See* Chapter 59), such double taxation will in all probability not be mitigated to any substantial degree by the allowance of foreign tax credits.[33] This problem may well be exacerbated by the treatment by foreign tax authorities of any remittances allowed tax-free under Rev. Proc. 65-17, 1965-1 C.B. 833 under U.S. law, as dividends subject to withholding tax. A similar problem will exist where the foreign entity actually makes payment to its U.S. parent of superroyalties. Many countries place strict limitations on the amounts of royalties payable by resident affiliates to their foreign parents. Superroyalty payment may either be blocked completely or treated as dividends. Further, complications with substantial U.S. tax consequences may arise in the case of related foreign entities where one uses intangibles developed by the other. Their earnings and profits and effective foreign tax rates will have to be recomputed for all U.S. tax purposes.

It is extremely difficult even to guess at how these problems will be dealt with. Unilateral concession by the IRS, as under obsolete Rev. Proc. 64-54, 1964-2 C.B. 1008, would frustrate the purpose of the amendments. On the other hand, intolerable double tax burdens would dampen any incentives to exploit U.S. technology abroad.

Comment: May one surmise that this is exactly what Congress foresees? If it be assumed that the major U.S. industrial assets are basically advanced technology, the operation of the amendments under discussion will exert very compelling pressure to utilize manufacturing intangibles in the U.S. and export the products rather than export the intangibles for exploitation abroad. If this purpose informed the new provisions, the committee reports reveal nothing of it. This is understandable, perhaps, in view of the many influential interests who will be affected.

Note also Act §1216, intended to provide tax incentives to U.S. research and development activities by providing that 50% of all amounts deductible as qualified R&D expenses be apportioned to U.S. source income with the remainder to be apportioned on the basis of gross sales or gross income. This, in effect, will increase the value of the limitation fraction under §904 for most affected taxpayers with a correspondingly greater currently usable foreign tax credit. This supersedes the prior law moratorium on all R&D apportionment and is to take effect in taxable years beginning after August 1, 1986, and on or before August 1, 1987. The Conference Committee [34] directs the IRS to undertake a study of the effectiveness of this incentive and of alternative incentives to U.S. R&D activities and of the compatibility of any such incentives as may be provided in regulations with foreign tax systems.

Comment: There is another side to the coin. Given the language of the new provisions and the committee reports, U.S. affiliates of foreign companies may reap substantial tax benefits in the form of increased deductions for royalties where foreign developed intangibles are used here. This is another of the facets of the amendments whose ultimate effect can only be guessed at.

E. Conclusions

The amendments under discussion, while taking up only a few lines of the voluminous 1986 Act, may well be one of the most significant changes in terms of total economic effect. They certainly do not bring any closer the day when some universally acceptable set of transfer pricing rules are adopted by the U.S. and its trading partners. While the committee reports justify the changes as necessary to prevent the loss of U.S. tax revenues via the exportation of intangibles, the costs of which were deducted by their U.S. developers, and mention the unsatisfactory and uncertain operation of the provisions of prior §§367,

[31] Organization for Economic Cooperation and Development.

[32] *Transfer Pricing and Multinational Enterprises*, Paris, 1979.

[33] In order to obtain any credit for the foreign taxes paid with respect to the amount treated as a superroyalty, the U.S. taxpayer will have to exhaust all "effective and practical remedies" to obtain a refund of such taxes from the foreign government and, failing this, relief through competent authority procedure. Rev. Rul. 80-231, 1980-2 C.B. 219. However, the IRS may well recognize that in most cases, pursuit of these remedies will be futile. Such foreign taxes will, therefore, normally be creditable. This, however, will be of little comfort to the taxpayer who cannot use the excess credits generated.

[34] Conf. Rep. at II-608.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

482, and 936 in subjecting to U.S. tax income which was economically earned in the U.S. or should be so considered, there may be, as indicated above, even more compelling but unexpressed goals. The relocation by numerous large U.S. manufacturing concerns of their operations abroad to take advantage of cheaper labor and benign regulatory conditions coupled with troublesome trade imbalance caused by the importation of foreign made products has long been a cause of concern. Since technology is an ever increasing factor in the production of goods, provisions which at the same time discourage the use abroad of intangibles developed by U.S. concerns and encourage the use here of intangibles developed by foreign companies have a strong appeal totally unrelated to the generation of tax revenues.

To those U.S. corporations which continue to utilize foreign subsidiaries or branches to manufacture goods, the new rules will present burdensome uncertainties. The amendments will almost certainly cause litigation, and their meaning will probably have to be settled by the courts. Further, there is no question but that considerable additional recordkeeping and reporting costs will result. The implications of these amendments are indeed very broad and, to a large degree, incalculable. The Conference Committee's observation, quoted above, that many difficult problems remain unresolved is quite true. The estimated budget effects of the amendments under discussion set forth in Table A.2 of the Conference Committee report, predicting increased revenues of $410 million for the period 1987-1991 appear to be extremely modest.

IV. Detailed Analysis of Valuation of Imports Provisions

The relevance of values claimed by importers of property purchased from related persons for customs purposes in determining an arm's length price has never been clearly established. It was held inconclusive in *Ross Glove Co. v. Comr.*,[35] and *Brittingham v. Comr.*[36] In deciding to enact §1059A, Congress was aware that customs valuation principles are somewhat different from those applicable under Regs. §1.482-2(e). It was thus stated in the Conference report that the Secretary is expected to issue regulations providing rules for coordinating customs and tax valuation principles taking into consideration freight charges, items of American content returned, and sales commissions where relevant. Tax Management was informed that a substantial discrepancy between customs valuations claimed and the price paid for automobiles imported by the U.S. distributor from a commonly controlled Japanese entity gave rise to the investigation underlying the administrative summonses involved in *U.S. v. Toyota Motor Corp.*[37] Had §1059A been in effect during the years involved in that case, the IRS may have been able to proceed directly to making an allocation under §482 on the basis of the customs valuation alone without the need for further investigation.

---

[35] 60 T.C. 569 (1963).
[36] 66 T.C. 373 (1976), aff'd *per curiam*, 598 F.2d 1375 (5th Cir. 1979).
[37] 561 F. Supp. 364 (C.D. Cal. 1983).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 69

FOREIGN COMPLIANCE PROVISIONS

Patricia R. Lesser, Esq.
Silverstein and Mullens
Washington, D.C.

I. Information Returns With Respect to Certain Foreign-Owned Corporations

A. Introduction

Code §6038A was added by TEFRA [1] to impose reporting requirements for certain foreign-owned corporations (hereafter "reporting corporations"). Reporting corporations to which the requirements of §6038A apply are, in general, both U.S. corporations and foreign corporations engaged in trade or business in the U.S., but only if such corporations are controlled by a foreign person. The control test is met if a foreign person owns 50% or more of the stock of the reporting corporation, either by value or by voting power.[2] The reporting corporation must satisfy these conditions at any time during a taxable year.[3] Prior to the 1986 TRA, the information to be disclosed related to each corporation which was a member of the same controlled group as the reporting corporation during its taxable year. A controlled group was defined in §6038A(c)(2) to generally include brother-sister corporations as well as the reporting corporation's parent or subsidiaries.

The information to be disclosed on each corporation pertains to the name, principal place of business, nature of business and country or countries in which organized or a resident; the manner in which the reporting corporation is related to each member corporation with whom it has a transaction; and to transactions between the reporting corporation and each foreign corporation which is a member of the same controlled group as the reporting corporation.[4]

The reporting requirements of §6038A were originally adopted to allow the Service to obtain sufficient information to closely monitor transactions involving foreign owned corporations and related parties in order to detect and challenge abusive transactions aimed at avoiding U.S. tax. As originally adopted, §6038A concerned only reporting with respect to the reporting corporation's transactions with other corporations in the same controlled group. Congress felt that the existing requirements were too narrow to prevent abuse because they did not apply to noncorporate related parties:[5]

> "The committee believes that transactions with noncorporate related persons, like transactions with related corporations, may be subject to transfer pricing and other abuses, and, therefore, that similar reporting requirements should apply to transactions with noncorporate related persons. The absence of parallel reporting rules may encourage taxpayers to include noncorporate related persons in their chain of ownership, so as to defeat the intended operation of section 6038A."

B. Overview

Section 1245 of the 1986 TRA amends §6038A(b) to provide that the information to be reported by U.S. corporations or foreign corporations doing business within the U.S. which are controlled by foreign persons, will relate to each person (not just corporations) which is a related party to the reporting corporation and which had any transaction with the reporting corporation during its taxable year. The amendment applies to taxable years beginning after December 31, 1986. Act §1245(c).

C. Detailed Analysis

Pursuant to §6038A(b), as amended, reporting corporations must disclose the required information with respect to each person which is a related party (as defined below) and which had any transactions with the reporting corporation during its taxable year. A "person" includes not only corporations but also partnerships, trusts, and individuals. A "related party" is defined as any person who is related to the reporting corporation within the meaning of §§482 (regarding allocation of income and deductions among taxpayers owned or controlled by the same interests), 267(b) (regarding nondeductibility of losses, expenses, and interest with respect to transactions between related taxpayers) or 707(b)(1) (relating to nondeductibility of losses in respect of losses from sales or exchanges of property between partners and the partnership).[6] The latter two sections were put into the Conference Agreement in order to provide objective related party tests.

Any two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the U.S., and whether or not affiliated) owned or controlled directly or indirectly by the same interests, are related parties for Code §482 purposes.

The following are related persons for purposes of 267(b):

---

[1] Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), P.L. 97-248, §339.
[2] §6038A(c)(1); Regs. §1.6038-2(b) and (c).
[3] §6038A(a).
[4] §6038A(b); Regs. §1.6038-2(f) and (g).
[5] S. Rep. No. 313, 99th Cong., 2d Sess. 413 (1986).
[6] §6038A(c)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

(1) Members of a family, as defined in subsection (c)(4);

(2) An individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations which are members of the same controlled group (as defined in subsection (f));

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

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

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

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

(8) A fiduciary of a trust and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(9) A person and an organization to which §501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

(10) A corporation and a partnership if the same persons own—

(a) more than 50% in value of the outstanding stock of the corporation, and

(b) more than 50% of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation; or

(12) An S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

For purposes of 707(b)(1), related parties are (1) a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or the profits interest, in such partnership, or (2) two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests.

As under prior law, the information that the reporting corporation must furnish for each person related to the name, principal place of business, nature of business, country or countries in which the person is organized or resident, manner in which the reporting corporation is related to each person, and transactions between the reporting corporation and all related foreign parties, whether or not a corporation. The reporting corporation may also have to disclose any other information as the Secretary may require for purposes of carrying out the provisions of §453C which relates to restrictions on the use of the installment method for certain sales.[7] The Conference Report notes that the limitations imposed by §6103, relating to confidentiality of information, will apply with respect to such information.[8]

II. Information Returns Required of U.S. Citizens and Residents Abroad

A. Introduction

U.S. citizens who are resident abroad and resident aliens are required to file U.S. tax returns and pay U.S. tax on their worldwide income. Aliens living abroad, under certain circumstances, may be considered as residents and, therefore, subject to these same duties. A number of provisions designed to avoid double taxation may reduce or eliminate the U.S. tax liability of U.S. citizens and resident aliens living abroad. For example, pursuant to §911 U.S. citizens or residents living abroad may elect to have their foreign earned income excluded, within limits, from gross income, and §901 may provide a tax credit against U.S. tax for foreign taxes paid on foreign source income.

Evidence gathered by the General Accounting Office shows that noncompliance with the filing requirements is much higher among U.S. citizens and residents living abroad than among those living in the U.S. The Senate Report [9] classifies nonfilers into two basic categories: negligent nonfilers, *i.e.*, those who assume that their residence overseas exempts them from U.S. tax or that a zero U.S. tax liability exempts them from their duty to file a return, and fraudulent nonfilers. Congress felt that the filing of a new Internal Revenue Service information return would help reduce the number of nonfilers in both categories, by providing notification of their duties to inadvertent nonfilers and by providing the IRS with information on U.S. citizens and residents living abroad to enable it to contact nonfilers and, if necessary, initiate collection actions. In the language of the Senate Report, "U.S. persons would no longer be able to move overseas and drop out of the U.S. tax system entirely." [10] A former purely voluntary IRS information return to be filed by passport applicants was discontinued because such applicants frequently refused to file the return.

B. Overview

Section 1234(a)(1) of the 1986 TRA adds §6039E which provides that an IRS information return must be filed in conjunction with a U.S. citizen's passport application or renewal and with an application for a permanent resident visa ("green card") in accordance with the immigration laws.[11]

The reporting requirement applies to passport and green card applications filed after December 31, 1987. If, however, regulations are adopted at an earlier date, the provision will apply as of the effective date of the regulations, but not before January 1, 1987. Act §1234(a)(3).

C. Detailed Analysis

The information to be disclosed in the return includes the taxpayer's identification number, if any, any foreign

[7] §6038A(b)(4). *See* Chapter 18, *supra*, for further discussion of §453C.

[8] Conf. Rep. No. 841, 99th Cong., 2d Sess., p. II-653.
[9] S. Rep. No. 313, 99th Cong., 2d Sess. 390 (1986).
[10] *Ibid.*
[11] §6039E(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

residence of a passport applicant, whether a green card applicant has been required to file a U.S. return for his/her most recent three taxable years, and any other information as prescribed by the Secretary.[12]

In addition to any other applicable penalties imposed by the Code, a penalty of $500 will apply for each case of noncompliance with the filing requirement, unless noncompliance is shown to be due to reasonable cause and not to willful neglect.[13] In this respect, the Senate Report indicates that it expects that the instructions accompanying the new information returns will clearly explain the filing requirements applicable to U.S. citizens and residents living abroad, thereby reducing the number of cases of negligent nonfilers.[14]

Notwithstanding any other provision of law, agencies which collect (or are required to collect) the new information returns must provide the returns to the Secretary as well as the name and any other identifying information they may have on individuals who refuse to file the return as required.[15]

The Secretary is authorized to exempt by regulation classes of individuals from the filing requirements if he determines that the information return is not necessary to carry out the purpose of this new section.[16]

III. Withholding on Certain Deferred Payments Outside the United States

A. Introduction

Section 3405 provides for withholding by the payors of periodic distributions (including annuities and pensions),[17] and nonperiodic distributions.[18] These withholding provisions are voluntary,[19] *i.e.*, the payee has the right to make an election not to have any amount withheld.

Section 3405 had originally been adopted with the purpose of finding a partial solution for the problems of collection of delinquent taxes due by pensioners, mostly of modest means, who found themselves unable to pay their income tax liabilities. The collection of tax problems are enhanced when pension payments are made to U.S. persons resident overseas. The IRS is frequently unable to collect tax in a foreign country and enforcement is therefore limited to locating assets within the U.S. which can be seized to satisfy the taxpayer's tax liability. Because the Code §911 exclusion does not apply to pension payments made to U.S. persons abroad, these persons are relatively likely to owe U.S. tax on such income. The Senate committee felt that withholding at source would, therefore, be particularly appropriate in this situation.[20]

B. Overview

Section 1234(b) of the 1986 TRA creates §3405(d)(13) which in effect imposes mandatory withholding on U.S. pension payments delivered outside of the U.S., unless the recipient certifies to the payor that he or she is not a U.S. citizen who is a bona fide resident of a foreign country or a tax avoidance expatriate under §877.

The mandatory withholding provisions apply to payments made after December 31, 1986. Act §1234(b)(2).

C. Detailed Analysis

New §3405(d)(13) provides that the general election for payees of periodic or nonperiodic distributions is not available in the case of periodic or nonperiodic distributions which are delivered outside the U.S. The election, however, will continue to be available if the recipient certifies to the payor that he or she is not a U.S. person resident overseas or a tax avoidance expatriate to whom §877 applies. The forms prescribed by the Secretary for the use of payees making the election not to have tax withheld under §3405, should be modified to enable payees living abroad to make such a certification.[21]

IV. Withholding Tax on Amounts Paid by Partnerships to Foreign Partners

A. Introduction

Foreign persons receiving U.S. source income are under certain circumstances subject to withholding at source by the payor. Withholding is generally required with respect to passive income paid to foreign persons because such persons generally have limited contacts with the U.S. By contrast, no withholding is required with respect to income which is effectively connected with the conduct of a U.S. trade or business since such persons generally have a substantial presence in the U.S. In such case, foreign persons are taxed essentially in the same way as U.S. persons.

Because partnerships are not taxable entities, if a foreign person invests in the U.S. through a partnership, the withholding rules that applied to partnership distributions prior to the 1986 TRA were determined by reference to the types of income earned by the partnership. If the income earned by the partnership would not have been subject to withholding if earned directly by a foreign person, then no withholding was imposed when that income was earned and distributed by a partnership. Thus, income effectively connected with a U.S. trade or business was not subject to withholding, whether earned by a foreign person directly or through a partnership.

Congress felt that this structure allowed passive investors to escape U.S. taxation. Foreign investors frequently buy interests in a partnership as a portfolio investment, representing the functional equivalent of stock investments. These investments generally "do not represent the type of substantial and continuing U.S. presence that justifies the absence of a withholding." [22]

[12] §6039E(b).
[13] §6039E(c).
[14] S. Rep. No. 313, 99th Cong., 2d Sess. 391 (1986).
[15] §6039E(d).
[16] §6039E(e).
[17] §3405(a)(1).
[18] §3405(b)(1).
[19] §3405(a)(2) and (b)(3).
[20] S. Rep. No. 313, 99th Cong., 2d Sess. 391 (1986).
[21] *Ibid.*
[22] S. Rep. No. 313, 99th Cong., 2d Sess. 414 (1986).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. Overview

The 1986 TRA adds Code §1446 to require that U.S. and foreign partnerships engaged in a U.S. trade or business deduct and withhold tax at the 20% rate on distributions to foreign partners. A limitation is provided if less than 80% of gross income is effectively connected with a U.S. trade or business.[23]

The new provisions apply to distributions after December 31, 1987, or, if earlier, the effective date provided under regulations but not before January 1, 1987. Act §1246(d).

C. Detailed Analysis

1. In General

The 1986 TRA imposes a 20% withholding tax on any amount distributed to a partner who is not a U.S. person, by a partnership which has any income, gain, or loss which is effectively connected or treated as effectively connected with the conduct of a trade or business in the U.S.[24]

As passed by the Senate, the withholding requirement applied only with respect to distributions from U.S. partnerships, but under the Act as finally enacted, the requirement applies to all partnerships, whether U.S. or foreign.

The withholding agent is any person described in Code §1441(a), *i.e.*, all persons in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the U.S.) having the control, receipt, custody, disposal or payment of partnership distributions to foreign partners. The Senate report clarifies that where interests in a publicly traded partnership are held through one or more nominees, the withholding agent is the last U.S. person in the chain of ownership following the principles of Code §1441(a).[25]

The Conference Report states that the Secretary will provide in regulations who is the proper withholding agent in the case of tiers of partnerships.[26]

Amounts withheld in excess of a foreign person's tax liability are treated as an overpayment of tax.[27]

The Secretary of the Treasury is granted general regulatory authority to implement the provisions of new Code §1446.

2. Limitation

A provision limiting the withholding on partnership distributions was included in the Conference agreement, as follows:

If less than 80% of the partnership's total gross income over the three-year tax period preceding a distribution is income effectively connected (or treated as effectively connected) with a U.S. trade or business over the same three-year period, then withholding is required only on the proportion of current distributions that the partnership's gross income effectively connected with its U.S. trade or business bears to the total gross income of the partnership during the previous three taxable years.[28] This proportion between the effectively connected gross income and total gross income over a three-year period is termed the "effectively connected percentage." Regulations will provide which are the withholding requirements in the case of a partnership which has effectively connected income for the first time.

The withholding under §1446(a) does not apply to distributions with respect to which a tax is required to be deducted and withheld under Code §§1441 or 1442, or would be required to be withheld but for a treaty.[29]

Section 1446, therefore, does not affect the provisions under Code §§1441 and 1442 generally requiring withholding of tax at a 30% rate. The Senate Report clarifies that any distribution by a partnership with effectively connected income is considered to come first out of dividends, certain interest, etc., received by the partnership. The remaining partnership distributions are subject to withholding at 20%.[30]

Regulations will coordinate the amount of tax to be withheld under new Code §1446(a) to take into account amounts deducted and withheld for FIRPTA purposes under Code §1445.[31]

Unless otherwise provided in regulations, the withholding requirements do not apply to partnerships with respect to which substantially all income which is effectively connected with a U.S. trade or business is properly allocated to U.S. partners under Code §704(b) and regulations thereunder.[32]

---

[23] Act §1246(a) adding Code §1446.
[24] Code §1446(a).
[25] S. Rep. No. 313, 99th Cong., 2d Sess. 414 (1986).
[26] Conf. Rep. No. 841, 99th Cong., 2d Sess., p. II-654 (1986).
[27] Act §1246(b) amending Code §6401(b)(2).
[28] Code §1446(b).
[29] Code §1446(c)(1).
[30] S. Rep. No. 313, 99th Cong., 2d Sess. 414 (1986).
[31] Code §1446(c)(3).
[32] Code §1446(c)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 70

CHANGES AFFECTING U.S. POSSESSIONS

Patricia R. Lesser, Esq.
Silverstein and Mullens
Washington, D.C.

I. Treatment of Interest on Obligations of the United States Received by Banks in Guam

A. Introduction

Section 882(e) generally provides that interest income from U.S. Government obligations, of corporations created or organized in or under the laws of a U.S. possession which carries out the banking business in a U.S. possession, is deemed to be effectively connected with the conduct of a U.S. trade or business. This income is, therefore, subject to U.S. tax on a net basis regardless of whether the corporation is engaged in a trade or business in the U.S.

B. Overview

Section 1236 of the Tax Reform Act of 1986 ("Act") amends §882(e) to provide that Guamanian banks are exempt from U.S. tax on interest from U.S. Government obligations if the Guamanian bank is treated as not being a foreign corporation pursuant to §881(b)(1), as amended, for the taxable year. The amendments to §882(e) apply to taxable years beginning after November 16, 1985. Act §1236(b).

C. Detailed Analysis

The 1986 TRA repeals the rule pursuant to which Guamanian banks are taxed on a net basis on interest paid on U.S. Government obligations. Interest on U.S. Government obligations paid to a Guamanian bank will not be deemed effectively connected with the conduct of a trade or business in the U.S. if the Guamanian corporation is not treated as a foreign corporation under §881(b)(1). Section 881(b)(1), as amended [1] contains anti-conduit rules which apply to corporations organized in Guam, American Samoa, the Northern Mariana Islands and the Virgin Islands.

II. Authority of Guam, American Samoa and Northern Mariana Islands to Enact Revenue Laws

A. Introduction

The income tax laws in effect in the U.S. are in force in Guam, the Commonwealth of the Northern Mariana Islands ("CNMI"), the U.S. Virgin Islands, and American Samoa, as their local income tax systems. The U.S. Internal Revenue Code is transformed into a taxing statute for each one of these jurisdictions (termed "possessions" of the U.S. for tax purposes) by substituting the name of each possession for the name "United States," where appropriate in the Code. This word substitution is known as the "mirror system." In applying the mirror system, possessions are generally treated as foreign countries with respect to the U.S. for U.S. tax purposes and the U.S. is generally treated as a foreign country with respect to each possession for possession tax purposes.

Even though the possessions apply the mirror system of taxation, the rules applicable to the U.S. tax relationship with the possessions varied among them.

Guam had no internal income tax law until 1950, when Congress enacted the Organic Act of 1950. Section 31 of this Act provided that "the income tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in Guam." In 1951, Treasury declared Guam's tax to be a separate and distinct territorial tax, subject to the word substitution system, thereby imposing the mirror system in Guam.[2]

With regard to the Virgin Islands, the Naval Appropriations Act of 1921 provided that the income tax laws in force in the U.S. are "likewise in force in the Virgin Islands, except that the proceeds of such taxes shall be paid into the treasury of the said islands." [3] This Act was interpreted to impose a mirror system of taxation. In 1976, the Naval Appropriations Act of 1921 was amended to provide the Virgin Islands with some degree of tax home rule. Congress permitted the Virgin Islands to impose up to a 10% surtax on the mirror system tax. No other local taxes on income could be imposed. The Virgin Islands was generally prohibited from reducing or rebating taxes imposed under the mirror system.

The Northern Mariana Islands has been a self-governing commonwealth since 1976. It is affiliated to the U.S. by a "Covenant" [4] which is the basis for applying the mirror system in the CNMI. The Covenant provides that the mirror system will apply in the CNMI in the same manner as those laws which are in force in Guam.[5] Section 601(c) of the Covenant provides that any reference in the Internal

[1] *See* IV, below.

[2] I.T. 4046, 1951-1 C.B. 57.
[3] 48 U.S.C. §1397.
[4] 48 U.S.C. §1681; P.L. 94-241.
[5] *Id.*, §601(a).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Revenue Code to Guam is deemed also to apply to the CNMI. A certain degree of tax autonomy is allowed under the Covenant which provides that the CNMI by local law may impose additional taxes and permit tax rebates, but only with respect to taxes on local source income.[6]

American Samoa, by contrast with the other U.S. possessions, is allowed to exercise autonomy over its own income tax system. In spite of this, American Samoa adopted the U.S. Internal Revenue Code as its local law in 1963, and has amended it only in a few instances to adapt it to local needs.

There have been several attempts to bring the U.S. possessions within the fold of the federal income tax system and to eliminate the mirror theory under which they operate. A plan was considered to extend the federal tax jurisdiction to the U.S. possessions so that taxpayers situated there would file their returns with the Internal Revenue Service (IRS) as if they were a resident in a state of the United States.

In late 1981, the Office of Management and Budget announced that the 1983 budget would include the elimination of the mirror system of income taxation. Although such proposal was dropped from the 1983 budget proposals, a confidential IRS memorandum stated that the Reagan administration was planning "sweeping changes" in the territorial tax systems. The memo stated that OMB had asked Treasury to draft a bill which would give the territories the full responsibility for creating their own local income taxes rather than using the current mirror system. Following this route, the 1986 TRA gives the U.S. possessions autonomy to create their own tax laws while coordinating the possessions' tax systems with the U.S. tax system to prevent them from becoming tax havens.[7]

Congress felt that the mirror system, which entails imposing the Code in its entirety as local law of each possession, may be totally inappropriate for the island economies of the U.S. possessions. The mirror system entails ambiguities which foster tax evasion and avoidance. It has some inherent problems which may have substantial adverse effects in the possessions. For example, amendments to the Code which are intended to be revenue-neutral in the U.S., might have adverse effects in the possessions because the revenue of these jurisdictions is collected from a different group of taxpayers than that of the U.S. In addition, the possessions lack the resources needed to enforce the mirror systems effectively.

The House committee stated its belief that the possessions should be provided with more local autonomy. At the same time, the committee did not intend to allow the possessions to be used as tax havens and therefore gave the authority to the possessions to reduce their tax on local income without, however, allowing them to be used to avoid U.S. tax.[8]

B. Overview

Act §1271 provides that nothing in the laws of the U.S. shall prevent Guam, American Samoa, or the CNMI from enacting tax laws, which shall apply in lieu of the mirror system with respect to income (1) from sources within, or effectively connected with the conduct of a trade or business within the possession, or (2) received or accrued by a resident of such possession.[9] Act §1271 does not apply to the Virgin Islands.

The grant of authority is, however, contingent upon an implementing agreement being in effect between the U.S. and each possession to alleviate certain problems relating to tax administration.[10]

C. Detailed Analysis

Act §1271(a) grants authority to Guam, American Samoa and the CNMI to determine their own income tax laws rather than applying the mirror system. In this way, Guam and the CNMI are placed at a par with American Samoa which already has authority over its local tax system. The authority to enact local taxes may be exercised by the CNMI without regard to any action that Guam might take.[11]

In an effort to coordinate the possessions tax systems with the U.S. tax system, the grant of authority is made contingent upon an implementing agreement being in effect (and so long as it is in effect) between the U.S. and each possession. The agreement must provide for (a) elimination of double taxation of income between the possession and the U.S.; (b) establishment of rules to prevent evasion or avoidance of U.S. income tax; (c) exchange of information between the possession and the U.S. for purposes of tax administration; and (d) resolution of other problems arising in connection with the administration of the tax laws of the possession or the U.S. Act §1271(b)(1)-(3).

In the event that an implementing agreement is not executed within a year of enactment, the Conference Report specifies that the House Committee on Ways and Means, the Senate Committee on Finance and the House Committee on Interior and Insular Affairs, are to receive a report from the Secretary on the status of negotiations and the reasons for not executing them.[12]

The local tax laws of the possessions may not discriminate against U.S. persons or any resident (corporate or otherwise) of any other possession.[13]

The revenue raised from the local tax laws by the possessions during the year of implementation (*i.e.*, the first fiscal year of the possession in which the local tax laws take effect) and the following four fiscal years, may not be less than the revenue (adjusted for inflation) raised during the last fiscal year in which the mirror system was in effect.[14]

---

[6] *Id.*, §602.
[7] Act §1271.
[8] H.R. Rep. No. 426, 99th Cong., 1st Sess. pp. 485-486 (1985) ("House Report").
[9] Act §1271(a).
[10] Act §1271(b).
[11] Act §1271(f)(3).
[12] H.R. Rep. No. 841, 99th Cong., 2d Sess. p. II-682 (1986) ("Conf. Rep.").
[13] Act §1271(d).
[14] Act §1271(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Under certain conditions, the Secretary of the Treasury may waive this requirement for a specific period. Act §1271(e)(2).

A procedure is devised to reinstate the "mirror system" of taxation in case that a possession fails to comply with the revenue raising or the nondiscrimination provisions.[15] For purposes of this section of the Act, the mirror system is defined as the provision of law (in effect before the date of enactment of the Act) which make the provisions of the income tax laws of the U.S. (as in effect from time to time) in effect in a possession of the U.S. Act §1271(f)(2).

D. Effective Date

These provisions are generally effective for taxable years beginning after December 31, 1986, provided, however, that an implementing agreement between the U.S. and the possession is in effect. Act §1277(a).

III. Exclusion of Possessions Source Income from the Gross Income of Certain Individuals

A. Introduction

Until 1972, application of the mirror system in Guam made Guam residents subject to U.S. tax on their U.S.-source income under §§871 and 932, frequently at a gross 30% withholding rate. In 1972, Congress enacted §935 which, in effect, provides that a Guam citizen is not a nonresident alien for U.S. tax purposes and a U.S. resident is not a nonresident alien for Guam tax purposes. An individual resident of Guam or the U.S. is required to file, with respect to income tax liability to those jurisdictions, only one tax return in the U.S. or Guam depending on whether the taxpayer was a U.S. or a Guamanian resident on the last day of the year ("the single filing rule"). Code §935(b). Withheld and estimated taxes paid to the jurisdiction in which a return is not filed may be claimed as a credit in the jurisdiction where a return is filed. §935(d).

Individuals who are residents of the CNMI are taxed in substantially the same way by virtue of the fact that Code references to Guam are deemed to include the CNMI.

American Samoa uses the U.S. Code as a model, with some modifications. Natives of American Samoa are still classified as nonresident aliens for U.S. tax purposes under §§932 and 871. Before the 1986 TRA, American Samoa was the only possession to which §931 still applied. Section 931 provided that, in effect, U.S. citizens who met certain threshold of possessions-source income were exempt from U.S. tax on all foreign source income. Any Samoa income which did not qualify for the §931 exclusion, could be credited under the §901 foreign tax credit rules, subject to the §904 limitation. A similar system applied with respect to Samoa citizens who met the threshold of U.S. source income.

B. Overview

Act §1272(a) amends Code §931 to provide that, for U.S. income tax purposes, the gross income of individuals who are bona fide residents of a specified possession during the entire taxable year will not include (1) income derived from sources within the specified possession, and (2) income effectively connected with the conduct of a trade or business by such individual within that possession.

The possessions to which §931, as amended, applies are Guam, the CNMI and American Samoa. It does not apply to the Virgin Islands. Amended §931(c).

C. Detailed Analysis

For U.S. income tax purposes, gross income of bona fide residents of Guam, American Samoa or the CNMI during the entire taxable year does not include income derived from sources within any one of the three possessions or income effectively connected with the conduct of a trade or business by that individual within any of the three possessions.[16] Amounts paid to a possession resident for services performed as an employee of the U.S. or one of its agencies are not excluded from gross income under §931(a).[17] Deductions (other than the personal exemptions under §151) and credits properly allocated and apportioned with the excluded income are not allowed for U.S. tax purposes.[18]

Residents of any of the three specified possessions are therefore generally required to file a tax return in the U.S. and to pay U.S. tax on a net basis on income which is not possession-source income (*i.e.*, U.S. or foreign source income). A possessions resident, however, is not required to file a U.S. tax return if his non-possession source income is less than the amount that gives rise to a filing requirement under generally applicable U.S. rules.[19]

Congress grants authority to the Secretary to prescribe by regulation under what circumstances income will be possession source income or deemed effectively connected to a possession trade or business,[20] and to determine when an individual is a bona fide resident of one of the possessions.[21] The House committee expects that the Secretary will use this authority to prevent abuse.

Act §1277(e) provides that, except as otherwise prescribed in regulations by the Secretary, a U.S. person who becomes a resident of Guam, American Samoa, or the CNMI will be subject to the rules of Code §877(c) for a period of 10 years from the date such person became such a resident. Under §877(c) such a U.S. person would have to pay tax to the U.S. on U.S. source income, income effectively connected with a U.S. trade or business, and gains from sales of certain assets with a U.S. connection. The Conference Report clarifies that the Secretary may provide exceptions in cases where he determines that adequate tax will be collected. No regulatory exception may contain a subjective standard which might consider a taxpayer's intent.[22]

Act §1272(b) amends Code §876 to provide that an alien individual who is a bona fide resident of Puerto Rico,

[15] Act §1271(e).

[16] Amended §931(a).
[17] Amended §931(d)(1).
[18] Amended §931(b).
[19] House Report at 486-87.
[20] Amended §931(d)(2).
[21] Amended §931(d)(3).
[22] Conf. Rep. at 682.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Guam, American Samoa or the CNMI is subject to U.S. income tax as provided under §1, *i.e.*, they are taxable on worldwide income under §1 as any other individual who is a resident alien of the U.S. Before the TRA 1986, this provision applied only with respect to aliens who were residents of Puerto Rico.

Act §1272(c) amends §3401(a)(8) so as to eliminate from the definition of wages subject to withholding, any remuneration paid to a U.S. citizen for services performed within a U.S. possession for the U.S. or one of its agencies to the extent the U.S. or its agencies withholds taxes under an agreement with the possession.

Act §1272(d) repeals §932 relating to treatment of citizens of possessions of the U.S. for U.S. income tax purposes and §935 relating to coordination of U.S. and Guam individual income taxes. Reference to §931 is deleted from §32(c)(1)(C) relating to individuals who are not eligible for the earned income credit.

D. Effective Date

Amendments made by Act §1272 apply to taxable years beginning after December 31, 1986. The changes regarding §877(c) with respect to U.S. persons becoming residents of the specified possessions, apply to dispositions after December 31, 1985, in taxable years ending after such date.

IV. Treatment of Corporations Organized in Guam, American Samoa, or the Northern Mariana Islands

A. Introduction

1. Definition of "U.S. Person" for Subpart F Purposes

For Subpart F purposes, it must be determined whether a foreign corporation has as its owners at least one U.S. person and if so, it must be determined whether U.S. persons are U.S. shareholders. The term "United States person" has the meaning assigned to it under §7701(a)(30), with some exceptions provided under §957(d).[23] Section 7701(a)(30) provides that "U.S. person" means a U.S. citizen or resident, a domestic partnership, a domestic corporation, and any estate or trust (other than a foreign estate or trust) within the meaning of §7701(a)(31).

Under §957(c), "U.S. person" does not include an individual citizen of the U.S. who is a resident of Puerto Rico, but only with respect to a corporation organized under the laws of Puerto Rico and only if dividends from that corporation are for purposes of §933(1) treated as income from sources within Puerto Rico.

Before the 1986 TRA, "U.S. person" did not include a U.S. citizen who was a resident of the Virgin Islands, with respect to a Virgin Islands corporation, if the individual paid income tax to the Virgin Islands on his worldwide income, nor did it include an individual who was a resident of any other U.S. possession, with respect to a corporation organized under the laws of the possession of which he was a resident, provided the individual was entitled to the benefits of Code §931(a). §957(d).

Pre-1986 TRA §931(a) provided that a U.S. citizen could exclude from gross income non U.S.-source income if during a three-year period 80% or more of the individual's gross income was from sources within a U.S. possession and if 50% or more of his gross income was derived from the active conduct of a trade or business within a U.S. possession, either on his own account or as an employee or agent of another.[24]

2. Exemption from Withholding Tax

Section 881(b) provides rules to prevent foreigners from using Virgin Islands or Guam corporations to avoid the U.S. 30% withholding tax on certain types of U.S. source income not effectively connected with a U.S. trade or business. Before the 1986 TRA, Code §881(b)(1) provided that a corporation created or organized under the laws of Guam or the Virgin Islands would not be treated as a foreign corporation if at all times during the taxable year less than 25% in value of its stock was owned directly or indirectly by foreign persons and if at least 20% of its gross income over a three-year period was derived from sources within Guam or the Virgin Islands.

B. Overview

A U.S. citizen who is a bona fide resident of Guam, American Samoa, or the CNMI is not a U.S. person with respect to a corporation organized under the laws of Guam, American Samoa, or the CNMI, for Subpart F purposes, if (1) 80% or more of the gross income of the corporation for a three-year period was derived from sources within the possession or was effectively connected with the conduct of a trade or business in the possession, and (2) 50% or more of the gross income of the corporation during such period was derived from the conduct of an active trade or business within the possession.[25]

Corporations organized or created in Guam, American Samoa, the CNMI, or the Virgin Islands or under the law of any such possession are not treated as foreign corporations for any taxable year, for purposes of the 30% withholding tax or the new branch profits tax under §884, if (1) less than 25% in value of the stock of such corporation is beneficially owned (directly or indirectly) by foreign persons at all times during the taxable year; (2) at least 65% of the gross income of such corporation is shown to the satisfaction of the Secretary to be effectively connected with the conduct of a possession or U.S. trade or business for the three-year period ending with the close of the corporation's taxable year; and (3) if no substantial part of the corporation's income is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of such a possession or the U.S.[26]

These amendments are generally effective for taxable years beginning after December 31, 1986. However, the

[23] Act §1224 redesignates subsection (d) as subsection (c). For a further discussion *see* Chapter 63, *supra*.

[24] *See* III, *supra*.

[25] Section 957(c), as amended by Act §§1224 and 1273(a).

[26] Section 881(b) as amended by Act §1273(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

amendments made with respect to Guam, American Samoa and the CNMI are effective only if and so long as an implementing agreement is in effect between the U.S. and the possession.[27]

C. *Detailed Analysis*

The Act implements anti-abuse provisions to prevent the use of corporations in Guam, American Samoa and the CNMI to avoid U.S. tax. For purposes of Code §957(c), as amended, the Secretary is granted regulatory authority to determine whether income is derived from sources within a possession, is effectively connected with the conduct of a trade or business or is derived from the active conduct of a trade or business in the possession.[28]

The post-1986 TRA rules under §881(b) to prevent foreigners from using possessions corporations as conduits to avoid U.S. withholding tax are applicable to Guam, American Samoa, the CNMI, as well as the Virgin Islands. The anti-conduit rules are tightened by substituting a requirement that 65% of a corporation's income be effectively connected with a trade or business in a possession or in the U.S., in place of the former 20% source of income requirement.

The Act also provides that no substantial part of a corporation's income can be used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of such a possession or the U.S. Act §1273(b). This new requirement prevents corporations from substantially reducing their taxable income with payments to persons not residents in one of the possessions or the U.S.

The provisions of Code §881(b), as amended, also apply to determine whether a Guam, American Samoa, CNMI or Virgin Islands corporation is a foreign corporation for purposes of the new branch profits tax under §884.

Section 1442 is amended to conform to the new requirements of Code §881(b)(1).

V. Coordination of U.S. and Virgin Islands Income Taxes

A. *Introduction*

Income taxation in the U.S. Virgin Islands results from the mirror system of taxation.[29] In addition, Congress enacted in 1954 the Virgin Islands Revised Organic Act which superimposed on the "mirror" system a rule which in effect exempted from U.S. tax an "inhabitant" of the Virgin Islands as long as the inhabitant paid tax to the Virgin Islands on its worldwide income.[30] Congress' intent when enacting this provision was to divert taxes on U.S. source income, paid by Virgin Islands residents, into the Virgin Islands Treasury. Before the 1986 TRA, therefore, bona fide inhabitants of the Virgin Islands reported and paid taxes on their worldwide income to the Virgin Islands, which, in turn, satisfied their U.S. income tax obligations.

The taxpayer resident in the Virgin Islands found himself in a unique position. Although every other U.S. person, wherever resident, is liable for U.S. taxation on his worldwide income, the U.S. person resident in the Virgin Islands completely escaped U.S. taxation by filing with and paying tax to the Virgin Islands government. Since the Virgin Islands taxed him as an alien or foreign entity, many of the advantages of the Code designed to attract foreign investment were applicable to his situation.

The interaction of Virgin Islands and U.S. tax law, in the words of the District Court of the Virgin Islands, raised the prospect of the Virgin Islands becoming the "ultimate tax shelter."[31] The Senate Report cited this case as an example of how the interaction of the U.S. and Virgin Islands tax laws exempted from all tax, in both the U.S. and the Virgin Islands, U.S. source income earned by a U.S. corporation qualifying as a Virgin Islands inhabitant.[32]

In addition, the Virgin Islands had a certain authority to adopt their own local tax laws either to impose a surtax of up to 10% of the mirror tax or to rebate its mirror tax on its resident individuals and on U.S. and Virgin Islands corporations that operate primarily in the Virgin Islands.

Finally Code §934A reduced the 30% withholding tax on certain payments to foreign persons (including U.S. persons) on Virgin Islands source income to 10%.

B. *Overview*

The Act revises the mirror system of taxation applicable in the Virgin Islands; it grants Treasury regulatory authority to implement the new rules; and provides for coordination between the U.S. and Virgin Islands tax systems.

Act §1274(a) provides that an individual who is a U.S. citizen or resident (other than a bona fide resident of the Virgin Islands) who derives Virgin Islands-source income or income effectively connected with a Virgin Islands trade or business, must file tax returns with both the U.S. and the Virgin Islands, and pays a pro rata amount of tax to each.[33]

Individuals who are bona fide residents of the Virgin Islands must file a tax return on their worldwide income in the Virgin Islands. A Virgin Islands resident will not incur tax liability towards the U.S. if he includes all items of income in his or her Virgin Islands tax return and if he identifies the source of each.[34]

The Virgin Islands is granted authority to enact nondiscriminatory local income taxes and any such taxes will be treated in the same manner as state and local taxes for U.S. income tax purposes. Act §1274(b).

These provisions apply to taxable years beginning after December 31, 1986. Act §1277(a).

C. *Detailed Analysis*

The mirror system is amended so that for purposes of determining the tax liability of an individual who is a

[27] Act §1277(a) and (b).
[28] Act §1273(a).
[29] *See* II, *supra*.
[30] Revised Organic Act, §28(a), 48 U.S.C. §1642.
[31] *Danbury v. U.S.*, 57 AFTR 2d 86-669 (D.V.I. 1986).
[32] S. Rep. No. 313, 99th Cong., 2d Sess. p. 478-79 (1986) ("Sen. Rep".).
[33] Amended §932(a) and (b).
[34] Amended §932(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

citizen or resident of the U.S. or the Virgin Islands, the U.S. is deemed to include the Virgin Islands (for purposes of determining U.S. tax liability) [35] and, under the Virgin Islands mirror Code, the Virgin Islands is deemed to include the U.S. (for purposes of determining Virgin Islands tax liability.) [36] A corporation organized in one jurisdiction, however, will continue to be treated, where relevant, as a foreign corporation for purposes of individual income taxation in the other jurisdiction.

1. Treatment of U.S. Citizens or Residents with Virgin Islands–Source Income

A U.S. citizen or resident (who is not a bona fide resident of the Virgin Islands at the close of the taxable year) who has Virgin Islands–source income or income effectively connected with the conduct of a Virgin Islands trade or business [37] (or an individual filing a joint return for the taxable year with such a U.S. citizen or resident [38]), must file two identical tax returns for the taxable year, one with the U.S. and one with the Virgin Islands.[39]

A portion of the U.S. tax liability will be paid to the Virgin Islands in lieu of applying the mirror system of taxation. This portion (*i.e.*, the "applicable percentage") is based on the ratio of Virgin Islands adjusted gross income to worldwide adjusted gross income. Only income derived from sources within the Virgin Islands and deductions properly allocated and apportioned, are taken into account to determine Virgin Islands adjusted gross income.[40] A credit against total U.S. tax liability will be granted for any tax paid on the individual's portion of Virgin Islands tax liability.[41]

2. Treatment of Virgin Islands Residents

An individual who is a bona fide resident of the Virgin Islands at the close of the taxable year (or an individual filing a joint return with such a resident), must file a tax return for the taxable year with the Virgin Islands. He will be liable, under the mirror system, to pay tax to the Virgin Islands on his worldwide income. Such individual reporting income from all sources on his Virgin Islands tax return and who identifies the source of each item of income, will not be required to include in gross income those items of income for purposes of determining his U.S. tax liability.[42] Therefore, a Virgin Islands individual resident who declares and identifies all sources of income in his Virgin Islands tax return will have no final tax liability for such year to the U.S.

In the case of a joint return, where only one spouse qualifies as a resident of the Virgin Islands, the residence of both spouses will be determined by that of the spouse with the greater adjusted gross income (determined without regard to community property laws) for the taxable year. New §932(d).

[35] New §932(a)(3).
[36] New §932(c)(3).
[37] New §932(a)(1)(A).
[38] New §932(a)(1)(B).
[39] New §932(a)(2).
[40] New §932(b)(1) and (2).
[41] New §932(b)(3).
[42] New §932(c)(4).

3. Authority to Impose Local Income Taxes

In addition to applying the mirror system of taxation, the Virgin Islands is given authority to enact nondiscriminatory local income taxes. Act §1274(b) clarifies that for purposes of determining U.S. tax liability, any such local taxes will be treated as state and local income taxes under Code §164 and not as foreign taxes creditable under §901. Before the 1986 TRA, the authority to impose local taxes was limited to a surtax of up to 10% of the mirror system tax.

Congress grants regulatory authority to the Secretary of the Treasury to determine, after consultation as appropriate with officials of the Virgin Islands, which of the Code provisions will not be applicable in the Virgin Islands, *i.e.*, which provisions will not be subject to the mirror system of taxation. Act §1274(c). The House Report anticipates that among the provisions which will not be mirrored will be those making references to possessions of the U.S.[43]

VI. Virgin Islands Corporations Allowed Possessions Tax Credit

A. Introduction

Code §936 provides an incentive for U.S. corporations to invest in certain U.S. possessions. The pre–1986 TRA definition of "possession" for §936 purposes did not include the Virgin Islands because of the unique system of taxation which operated in the Virgin Islands, *i.e.*, the mirror system of taxation as amended by §28(a) of the Revised Organic Act of the Virgin Islands.[44]

Even though §936 did not apply to the Virgin Islands, a similar result was achieved under Code §934(b) in conjunction with §28(a).

Because of §28(a), an "inhabitant" of the Virgin Islands was exempt from U.S. tax as long as the inhabitant paid tax to the Virgin Islands on its worldwide income. The term "inhabitant" in this context is generally interpreted to include individuals resident of the Virgin Islands, corporations organized under the laws of the Virgin Islands, and non-Virgin Islands corporations which have sufficient contacts with the Virgin Islands to be considered as "residents" of the Virgin Islands.

Section 934 denies the right to the Virgin Islands to make any grant, subsidy, or other payment which has the effect, either directly or indirectly, of reducing tax liability incurred to the Virgin Islands, except to the extent specifically provided in §934. Before the 1986 TRA, this prohibition did not apply to the extent a corporation (whether a U.S. or a Virgin Islands corporation) derived its income from sources without the United States provided the gross income and active business tests of 934(b) were satisfied.

B. Overview

The 1986 TRA, in effect, repeals the "inhabitants" rule. It provides that the Revised Organic Act will have no effect on any person's tax liability to the U.S.[45]

[43] House Report at 488.
[44] P.L. 83-517, 83d Cong., 2d Sess. §28(a) (1954).
[45] Act §1275(b) amending §7651(5)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Corporations operating in the Virgin Islands are eligible for the possessions tax credit provided under §936.[46]

The Virgin Islands is authorized to reduce Virgin Islands tax liability resulting from the application of the mirror system of taxation on income derived from sources within the Virgin Islands except if derived by U.S. citizens or residents subject to tax under §932(b) as amended.[47] The Virgin Islands may also reduce Virgin Islands tax liability incurred by certain foreign corporations with non-U.S. source income.[48]

C. *Detailed Analysis*

1. *Repeal of the Inhabitants Rule*

Amended §7651(5)(B) provides that §28(a) of the Revised Organic Act of the Virgin Islands will be deemed to have been enacted before the enactment of the Code, so that in case of conflict the Code controls. Furthermore, §28(a) of the Revised Organic Act will have no more effect on a person's income tax liability towards the U.S. Thus, for example, a U.S. person treated as an inhabitant of the Virgin Islands will continue to be fully subject to U.S. tax.

2. *Possessions Tax Credit*

Section 936, which provides a tax credit for corporations operating in Puerto Rico and certain other U.S. possessions, is extended to apply to corporations operating in the Virgin Islands.[49]

3. *Reduction of Virgin Islands Tax Liability*

The Virgin Islands is generally prohibited from reducing Virgin Islands tax liability resulting from application of the mirror system.

Under Act §1275(c)(2)(B), however, the Virgin Islands is given the authority to reduce or rebate Virgin Islands tax attributable to income derived from sources within the Virgin Islands or income effectively connected with a Virgin Islands trade or business.[50] The authority to reduce Virgin Islands tax liability applies regardless of whether the affected taxpayer derives any minimum specified percentage of its income from the Virgin Islands, as was the case under §934(b) before the 1986 TRA.

The authority to reduce taxes does not extend to the portion of U.S. tax liability payable to the Virgin Islands by individuals who are citizens or residents of the U.S. as determined under §932(b), as amended.[51]

The authority to reduce Virgin Islands taxes applies also with respect to tax liability of qualified foreign corporations attributable to non-U.S. source income and income which is not effectively connected with the conduct of a U.S. trade or business. A "qualified foreign corporation" for this purpose is any foreign corporation if less than 10% of the total voting power of its stock and the total value of its stock is owned or treated as owned (within the meaning of §958), by one or more U.S. persons.[52]

The authority to reduce taxes applies only to non-U.S. source income and income not effectively connected with a U.S. trade or business. Treasury is granted regulatory authority to determine when income is sourced in the U.S. or the Virgin Islands and when it is effectively connected with a U.S. or a Virgin Islands trade or business.[53] Congress anticipates that the regulations will contain anti-abuse provisions. The House and Senate Reports give examples of abuses to be prevented. A mainland resident, for example, who moves to the Virgin Islands while owning appreciated personal property and who sells that property in the Virgin Islands, should not escape all tax, both in the U.S. and the Virgin Islands, on that appreciation. Similarly, a resident of the Virgin Islands who owns financial assets such as stocks or debt of companies organized in, but the underlying value of which is primarily attributable to activities performed outside the Virgin Islands, should not escape tax on the ordinary income from those assets.[54] To prevent abuse, the Secretary may treat an individual as not a bona fide resident of the Virgin Islands.

Note that the authority to reduce Virgin Islands tax liability is granted on the condition that an agreement is in effect between the U.S. and the Virgin Islands containing safeguards against the avoidance or evasion of U.S. income tax.[55] Congress anticipates that the agreement will contain provisions to coordinate the tax administration in the U.S. and the Virgin Islands and will provide for exchange of information.

D. *Conforming Amendments*

As a consequence of the amendments described above, Code §934A relating to income tax rates on Virgin Islands source income is repealed.[56] Reference to Code §934(b) in §28(d)(3) (regarding the special limitation on the credit for foreign clinical testing expenses) is deleted.

E. *Effective Dates*

The amendments described above are generally effective for taxable years beginning after December 31, 1986. However, as indicated above, the authority to reduce Virgin Islands tax liability (and other conforming amendments of §1275(c) of the Act) are contingent upon an implementing agreement being in effect between the U.S. and the Virgin Islands. Act §1277(a).

If an implementing agreement is not executed within one year from the date of enactment, the Secretary of the Treasury must report to the Committee on Finance of the Senate, the Committee on Ways and Means, and the Committee on Interior and Insular Affairs of the House of Representatives, on the status of negotiations and the reasons for not having executed the agreement.[57]

---

[46] Act §1275(a) amending §936(d)(1).
[47] *See* V, *supra*.
[48] Act §1275(c) amending §934.
[49] Act §1275(a) amending §936(d). For a discussion of §936, as amended, *see* Chapter 66, *supra*.
[50] Amended §934(b)(1).
[51] Amended §934(b)(2). For a discussion of amended §932(b), *see* V, *supra*.
[52] Amended §934(b)(3).
[53] Amended §934(b)(4).
[54] House Report at 489; Sen. Rep. at 484.
[55] Act §1277(c).
[56] Act §1275(c)(3).
[57] Act §1277(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The amendments to Code §7651(5)(B) clarifying the treatment of Virgin Islands inhabitants for U.S. income tax purposes are effective for taxable years beginning after December 31, 1986, and any pre-1987 open year,[58] (*i.e.*, any taxable year beginning before January 1, 1987 if on the date of enactment of the Act, the assessment of a deficiency of income tax for such a taxable year is not barred by any law or rule of law [59]) but only with respect to income which is not derived from Virgin Islands sources or effectively connected with a Virgin Islands trade or business.[60]

To the extent that the Virgin Islands either collects tax by the date of enactment or, pursuant to an assessment issued by August 16, 1986, collects tax by January 1, 1987, on non-Virgin Islands source, non-Virgin Islands effectively connected income of a Virgin Islands inhabitant is subject to U.S. tax for pre-1987 taxable years, that Virgin Islands tax is to be creditable against the U.S. tax liability on that income. To the extent that Virgin Islands tax is imposed on U.S. income, it is to be creditable against U.S. tax on that particular income notwithstanding the general limitations on the foreign tax credit.[61]

An exception to the repeal of the inhabitants rule for pre-1987 open years is provided in favor of domestic corporations incorporated in Delaware on March 31, 1983, if such corporations were actively engaged, directly or through a subsidiary, in a trade or business in the Virgin Islands relating to marine activities.[62] Another exception is provided, within a certain limitation, for income derived from certain transactions carried out by corporations formed in Delaware on or about March 6, 1981 which have owned one or more office buildings in St. Thomas, Virgin Islands for at least five years before the Act's enactment date.[63]

VII. Amendments to Section 7654

A. Introduction

Federal statutes do not permit federal employers to withhold territorial income taxes. However, pre-1986 TRA §7654 provided an exception in the case of Guam. Pursuant to this section, the U.S. generally "covers over" (*i.e.*, transfers) to the treasury of Guam certain tax collected from individuals on Guamanian source income and withholding tax on military personnel in Guam. Similarly, Guam covers into the treasury of the U.S. certain tax collected from individuals on U.S. source income. Section 7654 and regulations thereunder set forth the general procedures to be followed by the governments of the U.S. and Guam in the division between the two governments of revenue derived from collections of the income taxes with respect to certain individuals to whom §935 applied and military personnel in Guam. Section 7654(a) provides that net collections on income tax attributable to U.S. source income were covered into the U.S. Treasury; net collections attributable to Guam source income were covered into the treasury of Guam; and any other net collections of such taxes were to be covered into the treasury of the jurisdiction in which the taxpayer was required to file a tax return under Code §935(b).

B. Overview

The 1986 TRA amends Code §7654 to provide that the U.S. will cover over to the treasuries of specified possessions (*i.e.*, Guam, American Samoa, the CNMI, and the Virgin Islands) all U.S. income tax paid by an individual who is a bona fide resident of one of the specified possessions.[64] In addition, the U.S. will cover over to the treasuries of Guam, American Samoa, the CNMI or the Virgin Islands, amounts of tax withheld on the compensation of U.S. Government personnel, including military personnel stationed or resident in one of the specified possessions.[65]

These provisions are effective for taxable years beginning after December 31, 1986. However, with respect to Guam, American Samoa, and the CNMI they will be in effect only if an implementing agreement, as provided under Act §1277 is in effect between the U.S. and the possession.

C. Detailed Analysis

The U.S. must collect income tax for each taxable year with respect to individuals to which §§931 or 932(c), as amended, applies. Individuals to whom §931 applies are bona fide residents of Guam, American Samoa or the CNMI. The gross income of these individuals for U.S. tax purposes does not include possessions-source income or income effectively connected with a possession trade or business.[66] The U.S. is, therefore, to cover over to the treasuries of the specified possessions, non-possession income.

An individual to whom §932(c), as amended, applies is a bona fide resident of the Virgin Islands (or an individual filing a joint return with a bona fide resident) on the last day of the taxable year. Such individuals must file a tax return in the Virgin Islands and are liable to the Virgin Islands for tax on their worldwide income. Such individuals have no final tax liability for such year to the U.S. Any taxes withheld and deposited in the U.S. from payments to such an individual, and any estimated tax payments properly made by such an individual to the U.S., will be covered over to the Virgin Islands Treasury and will be credited against the individual's Virgin Islands income tax liability.[67]

As under pre-1986 TRA law, the amounts to be transferred are net collections of tax imposed under Chapter 1 of the Code, properly adjusted for any credits allowed against the tax liability and any refunds made of income taxes for the year.[68] The transfers of tax must continue to be made at least annually.[69]

[58] Act §1277(c)(2)(A).
[59] Act §1277(c)(2)(C).
[60] Act §1277(c)(2)(B)(i).
[61] Conf. Rep. at II-682.
[62] Act §1277(c)(2)(D).
[63] Act §1277(c)(2)(E).
[64] Act §1276.
[65] Code §7654(d), as amended.
[66] *See* III, *supra*.
[67] *See* V, *supra*.
[68] §7654(b)(1).
[69] §7654(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The cover over amounts of taxes deducted and withheld by the U.S. under Chapter 24 on compensation paid to members of the Armed Forces is extended to apply with respect to individuals stationed in Guam, American Samoa, the CNMI and the Virgin Islands. The U.S. must also cover over to the Treasuries of the possessions amounts deducted and withheld with respect to amounts paid to other employees of the U.S. (or an agency thereof) for services rendered in a specified possession, unless §931 or §932(c) applies.[70]

The Secretary is granted regulatory authority to implement the amendments to §7654 (as well as §§931 and 932), including regulations prohibiting the rebate of taxes which are covered over and attributable to U.S. source income. The regulations will also specify the type of information which will have to be furnished by individuals to whom such sections may apply.[71]

[70] New §7654(d)(2).

[71] Amended §7654(e).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 71

MISCELLANEOUS FOREIGN PROVISIONS

Deborah M. Beers, Esq.
Patricia R. Lesser, Esq.
Harrison B. McCawley, Esq.
Silverstein and Mullens
Washington, D.C.

I. Foreign Personal Holding Stock Ownership Test Modified [Act §1222(b)]

A. Background—Pre-1986 TRA Law

The foreign personal holding company (FPHC) provisions have been part of the Internal Revenue Code since 1937 when they were enacted as a complement to the personal holding company (PHC) legislation of 1934 to prevent the abuse known as the foreign "incorporated pocketbook," whereby United States shareholders would accumulate in foreign corporations certain types of passive income without incurring any U.S. tax liability. The FPHC rules require "United States shareholders" of the foreign corporation to include in gross income their proportionate share of the corporation's "undistributed foreign personal holding company income" (UFPHCI). "United States shareholders" [1] may include U.S. citizens or residents, U.S. corporations, U.S. partnerships, or estates and trusts (other than those estates and trusts whose gross income includes only income from sources within the United States).

For purposes of determining which corporations meet the definition of FPHC, Code §552 sets forth both a "gross income test" and a "stock ownership test." Under the gross income test, at least 60% of the gross income of a foreign corporation for the taxable year must be foreign personal holding company income for it initially to qualify as an FPHC.[2] After the initial qualification as an FPHC, the gross income test will be satisfied if the corporation in any subsequent year has foreign personal holding company income equal to at least 50% of its gross income during the taxable year.[3] Foreign personal holding company income, under Code §553, includes most types of passive investment income such as dividends, interest, rents, and royalties.

The "stock ownership test" requires that at any time during the taxable year more than 50% in value of the outstanding stock of a foreign corporation must be owned directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States (the United States group).[4] For purposes of determining the ownership of stock under this section, the attribution rules of Code §554 apply.

The stock ownership test, for purposes of the FPHC rules, is similar, although not identical, to that which appears in Code §957(a) which defines the term "controlled foreign corporation" (CFC). A CFC includes any foreign corporation of which more than 50% of the total combined voting power of all classes of stock entitled to vote is owned, actually or constructively, by United States shareholders on any day during the taxable year of such foreign corporation. For purposes of determining whether the 50% ownership test is met, the constructive ownership rules of §958 apply.

B. Detailed Analysis of 1986 TRA Provisions

Section 1222(b) of the Act amends the definition of foreign personal holding company with respect to the stock ownership requirement of §552(a)(2) to state that, if, at any time during the taxable year, more than 50% of the total combined voting power of all classes of stock of the corporation entitled to vote, *or* more than 50% of the total value of the stock of the corporation is owned directly or indirectly by or for not more than five individuals who are citizens or residents of the United States, the the corporation will be a foreign personal holding company, assuming the gross income requirements also are met.

A similar amendment to the CFC rules is contained in §1222(a) of the Act, so that ownership by United States shareholders of more than 50% of the total combined voting power *or* the total value of the stock of a foreign corporation will result in that corporation being considered a CFC during the taxable year. The Act thus coordinates to a greater extent the ownership requirements under the FPHC and CFC provisions.[5] However, under Code §951(d), as

[1] Code §551(a).
[2] Code §552(a).
[3] *Id.* The gross income percentage will rise to 60% again after three consecutive taxable years expire in each of which less than 50% of the corporation's gross income is FPHCI or until the taxable year during the whole of which the stock ownership test is not satisfied. *See* Regs. §1.552-2(a)(2)(ii).
[4] Code §552(a)(2).
[5] The CFC and FPHC ownership requirements still are not identical, however, since the "more than 50% of the vote or value" test must be applied, in the case of a CFC, by taking into account only the ownership of stock by "U.S. shareholders" (generally ten percent owners). Thus, a foreign corporation in which four unrelated U.S. individuals each owned nine percent of the stock and another U.S. individual owned 20% would satisfy the stock ownership requirements for a FPHC but not for a CFC.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

amended by the Tax Reform Act of 1984,[6] a CFC's Subpart F income will be taxable under Subpart F, but not under the FPHC rules, to the extent that it otherwise would be taxable under both.

The conferees rejected a House proposal under which the threshold for imposition of tax under the FPHC and CFC rules would be changed from "more than 50%" of the vote or value to "50% or more" of the vote or value of the corporation.[7] The conferees' reason for rejecting a change in the threshold percentage was that the Internal Revenue Service can, pursuant to Regs. §1.957-1(b), deem foreign corporations effectively controlled by ten percent U.S. shareholders to meet the "more than 50%" ownership test even though that requirement is otherwise not technically met.[8] Despite this regulatory authority, however, the amendment made by the Act reflects a concern on the part of Congress that taxpayers could manipulate a single factor test.[9]

C. Effective Date

The amendments to the FPHC stock ownership requirements apply to taxable years of foreign corporations beginning after December 31, 1986. However, where the FPHC also qualifies as a CFC, the amendments take effect on August 16, 1986, for purposes of determining whether the gross income of the United States shareholders of the CFC includes their pro rata share of the corporation's increase in earnings invested in United States property for the year.[10]

II. Foreign Personal Holding Company Taxable Income Includes Effectively Connected Gain or Loss Only [Act §1225(b)]

A. Background—Pre-1986 TRA Law

Section 541 of the Code imposes a 50% tax on the undistributed personal holding company income (as defined in §545 of the Code) of every personal holding company (PHC). This tax, like the accumulated earnings tax described in III, below, designed to discourage shareholders from accumulating earnings, taxable at the (under pre-1986 TRA law) generally lower corporate rate, in their closely-held corporations. The PHC tax is imposed only on those corporations meeting both an ordinary gross income requirement and a stock ownership requirement. Under the gross income test, at least 60% of the adjusted ordinary gross income of a corporation for the taxable year must be PHC income. Under the stock ownership test, a corporation will be considered a PHC if, at any time during the last half of the taxable year, more than 50% in value of its outstanding stock is owned directly or indirectly by or for not more than five individuals.

The PHC tax is imposed on "undistributed personal holding income" which is calculated by making several adjustments to the regular taxable income of a corporation, including deductions for net capital gains (and certain capital losses).[11] The reason for the deduction for net capital gains is that there is little incentive for a shareholder to accumulate capital gains in a corporation.

Foreign corporations generally are subject to the PHC tax only if they have shareholders that would be subject to federal income tax on a distribution from the PHC. However, in determining the PHC tax on the income of a foreign corporation, only U.S. source income is taken into account. For this purpose, net capital gain income realized by a foreign corporation trading in stock, securities or commodities will not be considered U.S. source income since it is not effectively connected with a U.S. trade or business.[12] Therefore, although such capital gains may be deducted in determining the personal holding company income of a foreign corporation (thus reducing the PHC tax), they would not otherwise be subject to U.S. tax.

B. Detailed Analysis of 1986 TRA Provisions

Section 1225(b) of the Act amends Code §545 by adding paragraph (7) to §545(b)(relating to adjustments to taxable income for purposes of computing the personal holding company tax) to provide that, in the case of a foreign corporation, only capital gains and losses which are effectively connected with the conduct of a trade or business within the United States, and are not exempt from tax under treaty, may be taken into account in computing undistributed personal holding company income. The reason for the change, as noted above, is that capital gains which are not effectively connected to a United States trade or business are not subject to U.S. tax, but, prior to the amendment, they could nevertheless reduce the personal holding company tax of the foreign corporation. By allowing a reduction in undistributed personal holding company income only with respect to capital gains that are effectively connected with the conduct of a U.S. trade or business and not exempt from taxation by treaty, this potential for abuse is eliminated.[13]

C. Effective Date

The amendment is effective for gains and losses realized on or after March 1, 1986.[14]

III. Accumulated Taxable Income of Foreign Corporations Effectively Connected Gain Only Taken Into Account [Act §1225(a)]

A. Background—Pre-1986 TRA Law

Similar to the personal holding company tax described in II above, the accumulated earnings tax of §531 of the Code imposes a tax of (i) 27½% on the accumulated

[6] P.L. 98-369, §132(c)(1).

[7] *See* H.R. Rep. No. 841, 99th Cong. 2d Sess., p. II-626-627 (1986)("Conference Report").

[8] Conference Report at p. II-627.

[9] *See* S. Rep. No. 313, 99th Cong. 2d Sess., p. 371 (1986)("Senate Report").

[10] *See* Act §1222(c).

[11] *See* generally Code §545(b) and (with respect to net capital gains) §545(b)(5).

[12] *See* Code §864(b)(2)(A)(ii) and Senate Report at p. 431.

[13] *See* H. R. No. 426, 99th Cong. 1st Sess., pp. 436-437 (1985)("House Report"); Senate Report at pp. 431-432 (1986); and Conference Report at p. II-628 (1986).

[14] Act §1225(c). This effective date (March 1, 1986) appears in the language of the bill as printed in the Conference Report at p. I-500 (1986). The "Statement of Managers" portion of the Conference Report, however, contains a January 1, 1986 effective date at p. II-628.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

taxable income of a corporation not in excess of $100,000 plus (ii) 38½% of the accumulated taxable income of the corporation in excess of $100,000. As with the PHC provisions, in computing the "accumulated taxable income" of a corporation, certain adjustments, described in §535(b) of the Code, are taken into account. Among these are adjustments for net capital gains and certain capital losses of the corporation.[15]

As is the case with the PHC, foreign corporations generally are subject to the accumulated earnings tax only if they have shareholders that would be subject to a U.S. tax on a distribution from such corporation. Again, only U.S. source income, which does not include capital gains and losses not effectively connected to the conduct of a United States trade or business,[16] is subject to the accumulated earnings tax. Nevertheless, capital gains that are not subject to U.S. tax may reduce accumulated taxable income under §535 of the Code.

B. Detailed Analysis of 1986 TRA Provisions

Section 1225(a) of the Act amends Code §535 by adding paragraph (9) to §535(b)(relating to adjustments to taxable income for purposes of computing the accumulated earnings tax) to provide that, in the case of a foreign corporation, only capital gains and losses which are effectively connected with the conduct of a trade or business within the United States and are not exempt from tax under treaty may be taken into account in computing accumulated taxable income.

C. Effective Date

The amendment is effective for gains and losses realized on or after March 1, 1986.[17]

IV. Section 911 Exclusion Modified

A. Introduction

U.S. citizens and residents are generally subject to U.S. tax on their worldwide income. To prevent double taxation, a tax credit is allowed under §§901-908 for foreign taxes paid on foreign income. Under certain conditions, however, Code §911 allows U.S. citizens or residents to exclude foreign earned income from their gross income subject to U.S. tax.

U.S. citizens whose tax home is in a foreign country and who satisfy certain physical presence abroad or bona fide foreign residence tests and U.S. residents whose tax home is in a foreign country and who satisfy certain physical presence abroad tests, may elect to exclude from gross income their foreign earned income up to a certain amount and foreign housing costs exceeding a certain base amount.[18]

The maximum amount of foreign earned income which could be excluded for taxable years beginning in 1986 and 1987 was $80,000, and it was scheduled to increase to $85,000 in 1988, $90,000 in 1989 and $95,000 in 1990 and subsequent years.[19] This scheduled increase in the exclusion results from the Tax Reform Act of 1984, which delayed until 1988 the increases that the Economic Recovery Act of 1981 had scheduled to begin in 1984. P.L. 98-369, §17.

B. Overview

Pursuant to the 1986 TRA, the maximum amount of foreign earned income which may be excluded from gross income by U.S. citizens and residents who live and work abroad is reduced to $70,000 per year.[20]

The §911 exclusion is not available to U.S. citizens violating Federal travel restrictions.[21]

These amendments are in effect for taxable years beginning after December 31, 1986. Act §1233(c).

C. Detailed Analysis

1. Foreign Earned Income Exclusion Amount

The reduction of the limitation on the foreign earned income exclusion follows the lowering of tax rates for U.S. citizens and residents and the corresponding repeal or restriction of a number of tax preferences. The amount of the exclusion will continue to be computed at the annual rate on a daily basis. Code §911(b)(2)(A).

2. Disallowance for Violation of Foreign Travel Restrictions

If an individual engages in travel (or any transaction in connection with such travel) in a foreign country in violation of the law, (a) any foreign earned income for Code §911 purposes will not include income from sources within the foreign country attributable to services performed during the period of illegal travel; (b) housing expenses will not include expenses allocable to such period for housing in the foreign country or for housing of the spouse or dependents of the taxpayer in another country while the taxpayer is present in the foreign country; and (c) the taxpayer will not be treated as a bona fide resident of, or as present in, a foreign country for any day during which the individual violates the law.[22]

The travel restrictions are those which result from regulations adopted under the Trading with the Enemy Act (50 U.S.C. App. 1 *et seq.*) or the International Emergency Economic Powers Act (50 U.S.C. 1701 *et seq.*) and which include provisions generally prohibiting citizens and residents of the U.S. from engaging in transactions related to travel to, from, or within a foreign country, including any such prohibitions adopted in the future.[23]

The Senate Report lists five countries (*i.e.*, North Korea, Cuba, Vietnam, Kampuchea, and Libya) with re-

[15] *See* Code §535(b)(5) and (6).
[16] *See* Code §864(b)(2)(A)(ii).
[17] Act §1225(c). The March 1, 1986 date appears in the language of the bill as printed in the Conference Report at p. I-500. The "Statement of Managers" portion of the Conference Report, however, contains a January 1, 1986 effective date at p. II-628.
[18] *See* Code §911(a), (b), and (c); Conference Report, p. II-636. Note that certain types of income, including compensation from the U.S. government or agency, are not eligible for the exclusion. *See* §911(b)(1)(B).
[19] Code §911(b)(2)(A).
[20] Act §1233(a), amending Code §911(b)(2)(A).
[21] Act §1233(b), amending Code §911(d) by redesignating paragraph (8) as paragraph (9) and by inserting a new paragraph (8) after paragraph (7).
[22] Code §911(d)(8), as amended.
[23] Code §911(d)(8)(B); Senate Report at 389.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

spect to which Treasury regulations restrict transactions related to travel of U.S. citizens and residents, except if otherwise authorized by the Treasury Department.[24]

The disallowance provisions of Code §911(d)(8), as amended, do not apply to an individual if such individual's activities in a foreign country where travel restrictions apply are not in violation of the law.[25] The travel restrictions are, in certain cases, subject to exceptions which vary with each foreign country. The Senate Report mentions a few examples of such exceptions. Thus, the restrictions applicable to travel in Cuba do not extend to travel in order to visit close family members. The restrictions concerning Libya apply to all travel transactions after January 31, 1986, unless necessary to effect the individual's departure from that country or for journalistic activities.[26] Individuals to which these exceptions apply are not denied the tax benefits of Code §911(a).

V. Income of Foreign Governments

A. Introduction

The basic provisions dealing with the tax treatment of foreign governments and international organizations are contained in Code §892 and regulations thereunder.

Prior to the 1986 TRA, Code §892 provided that foreign governments and international organizations did not include in gross income, and were therefore exempt from tax on income received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States.

However, the regulations provide that income derived by an integral part or controlled entity of a foreign sovereign from commercial activities in the U.S. is not income of a foreign government for purposes of the Code §892 exemption and is therefore taxed under the appropriate provisions of the Code.[27]

The regulations define a "foreign government" as consisting only of integral parts (such as agencies or bureaus) or controlled entities (such as corporations) of a foreign sovereign to the extent not engaged in commercial activities in the U.S. A controlled entity is one which is wholly owned and controlled, directly or indirectly through one or more controlled entities, by a foreign sovereign. The net earnings of an integral part or a controlled entity of a foreign government must be credited to their own accounts or to other accounts of the foreign government, with no portion inuring to the benefit of any private person.[28]

Commercial activities are defined as activities conducted in the U.S. which are ordinarily conducted with a view towards the current or future production of income, whether or not such income is from sources within the U.S.[29] However, the regulations clarify that investments in stocks (whether or not a controlling interest investment) bonds or other securities, loans, net leases on real property, land which is not producing income, or the holding of deposits in banks, are not commercial activities. All the facts and circumstances are considered to determine whether an activity relating to the above properties constitutes an investment. An activity will not cease to be an investment solely because of the volume of transactions of the activity.[30]

The regulations further provide that performances and exhibitions within the U.S. of amateur athletic events and events devoted to the promotion of the arts by cultural organizations are not commercial activities.[31]

A foreign central bank of issue that failed to qualify for the Code §892 exemption could still be exempt from tax on the items of income enumerated in Code §895.

The extent of the exemption under Code §892 was not clear. Confusion also existed with respect to a foreign government's status vis-a-vis income tax treaties, in particular those treaties which do not include provisions specifically dealing with income earned by governments. Because recent treaties generally allow protection only to residents of the treaty partner country, a determination had to be made as to whether a government was a "resident" within the definitions given under the treaties. *See* Senate Report at 416.

Congress felt that the foreign government exemption on investment income, which extended to business corporations wholly owned by foreign governments, discriminated against privately-owned foreign corporations which are subject to U.S. tax on U.S. source investment income.[32]

Furthermore, prior to the 1986 TRA, income (such as dividends and interest) derived by foreign governments or governmental entities from U.S. businesses that they control was exempt. For example, if a foreign government bought a controlling interest in a U.S. corporation, dividends and interest payments from that corporation to the foreign government escaped U.S. shareholder level tax. Congress felt that payments to a controlling entity are in the nature of a return on a direct investment not on a portfolio investment, and should therefore not be exempt.[33]

B. Overview

The 1986 TRA codifies the rule limiting the foreign government tax exemption of Code §892 to investment income and makes taxable the commercial activities of foreign governments. The Act does not affect the current system of taxation of international organizations.

The provisions of revised §892 are effective for payments received on or after July 1, 1986, but no withholding will be required by reason of the amendment on payments

[24] Senate Report at 389.
[25] Code §911(d)(8)(C).
[26] Senate Report at 389.
[27] Regs. §1.892-1(a)(3).
[28] Regs. §1.892-1(b).
[29] Regs. §1.892-1(c)(1).
[30] Regs. §1.892-1(c)(2).
[31] Regs. §1.892-1(c)(2)(ii).
[32] Senate Report at 416.
[33] *Ibid.*

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

made before the date of enactment of the Act (October 22, 1986). Act §1247(b).

C. *Detailed Analysis*

1. *Investment Income*

Code §892(a)(1) lists the types of income received by foreign governments which may be excluded from gross income and which are therefore exempt from U.S. income taxation. As under prior law, these cover income from investments in the U.S. in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks in the U.S. of money belonging to such foreign governments. It is extended to cover income from investments in financial instruments held by foreign governments in the execution of governmental financial and monetary policy. The statutory language of the exemption under revised §892(a) no longer refers to income from "any other source" within the United States. This language was too vague and gave rise to uncertainty concerning the exact scope of the exemption. In particular, it was not clear whether the statute was intended to exempt income from commercial sources.

2. *Commercial Income*

The foreign government exemption does not extend to income received directly or indirectly by a foreign government from commercial activities. The 1986 TRA therefore codified the rule already provided by Regs. §1.892-1 that income from commercial activities is not investment income and therefore is not exempt from U.S. tax. The Treasury's position resulted from a narrow reading of the "income from any other source within the U.S." language of former Code §892.

Income excluded from the exemption is income (a) derived from the conduct by a foreign government of any commercial activity, whether within or outside the U.S., or (b) received from or by a controlled commercial entity (including, for example, dividend and interest payments).[34]

A commercial activity is therefore defined to include ownership of a controlling interest in a corporation or other entity engaged in trade or business in the U.S. As drafted by the Senate, the foreign government exemption was denied to any entity controlled by a foreign government if any other entity controlled by that government engaged in commercial activity. This provision was deleted from the Act. However, the Conference Report anticipates that regulations to be adopted by the Secretary will address the potential risk of shifting of income from commercial arms of foreign governments to other related entities and will provide rules to replace the Senate provision that attributed commercial activity of one controlled entity to other controlled entities.[35]

If a controlled entity is itself engaged in commercial activity anywhere in the world, its income is treated like the income of a privately owned entity. If the controlled entity is not itself engaged in commercial activity, the Act provides tax exemption for certain investment income earned by that entity and for interest and dividends paid from the entity to the government.[36]

The Senate Report expresses its belief that income derived by foreign governments' athletic teams and cultural groups should not be treated differently from similar income earned by privately-owned foreign professional teams or groups.[37]

The Senate Report clarifies that it intends that, for treaty purposes, a foreign government (as well as agencies, bureaus or controlled corporations) be treated as a resident of its country, unless it does not grant reciprocal treatment to the U.S.[38]

3. *Controlled Commercial Entity*

The foreign government exception does not apply to controlled entities that engage in any commercial activity anywhere in the world. However, for purposes of this definition, a central bank of issue is treated as a controlled commercial entity only if it is engaged in commercial activities within the U.S. Code §892(a)(2).

A foreign government has a controlling interest in an entity (whether U.S. or foreign) if it holds directly or indirectly, an interest of 50% or more, by vote or value, in that entity or any other interest that allows or would allow effective control of such entity.[39]

4. *International Organizations*

As drafted by the Senate, the amendments to Code §892 also applied with respect to international organizations, as described in Code §7701(a)(18). Section 1247 of the Act, as finally enacted, does not affect the tax treatment of international organizations. The statutory provisions applicable to these organizations are now contained in Code §892(b), which makes no changes to the tax regime which applied prior to the Act.

The Secretary is granted general regulatory authority to implement the provisions of Code §892, as amended. Code §892(c).

VI. Effectively Connected Income Will Retain its Character in Subsequent Years

A. *Pre-1986 TRA Law*

The characterization of a foreign person's income as effectively connected with the conduct of a U.S. trade or business changes the manner in which such income is taxed in the U.S. Income that is effectively connected with a U.S. trade or business is taxed in the U.S. on a net basis at graduated rates. Income that is not effectively connected is generally subject to a 30% withholding tax (or lower treaty rate) on the gross amount, although certain types of such income, such as portfolio interest income, are exempt from U.S. tax. Non-effectively connected capital gains of foreign taxpayers are generally not subject to U.S. tax, with some exceptions such as for real property gains.

[34] Code §892(a)(2)(A). *See* Senate Report at 416-417.
[35] Conference Report, p. II-655.
[36] *Ibid.*
[37] Senate Report at 418.
[38] *Ibid.*
[39] Code §892(a)(2)(B).

The regulations contain rules to determine whether income, gain or loss of a nonresident alien individual or a foreign corporation that is engaged in a U.S. trade or business in the U.S. at any time during the taxable year is effectively connected income for that year.[40] Regs. §1.864-3(a) provides that no income, gain or loss of a nonresident alien individual or a foreign corporation that is at no time during the taxable year engaged in a U.S. trade or business is to be treated as effectively connected for the taxable year with the conduct of a U.S. trade or business. The regulations further provide that this rule applies even though the income, gain or loss would have been treated as effectively connected if such income, gain or loss was attributable to an earlier taxable year when the taxpayer was engaged in a U.S. trade or business.[41]

The application of the effectively connected income concept on a strict annual basis enabled foreign taxpayers to avoid having income or gain characterized as effectively connected by, for example, effecting a sale on the installment basis. Installment payments received in years after the cessation of the U.S. trade or business were not treated as effectively connected. Congress expressed its belief that income earned by a foreign person's U.S. trade or business should be taxed as such, regardless of whether recognition of that income is deferred until a later taxable year. Similar considerations apply with respect to the performance of services. Similarly, unrealized gains on appreciated property used in a foreign person's U.S. trade or business could escape U.S. tax liability if sold or exchanged after the U.S. trade or business had ceased to exist.[42]

B. Overview

Act §1242 amends §864(c) to provide two cases in which a foreign person's income or gain effectively connected with a trade or business in the U.S. will retain its character in years after the foreign taxpayer ceases to conduct the U.S. trade or business.

The provisions of amended §864(c) apply to taxable years beginning after December 31, 1986. Act §1242(c).

C. Detailed Analysis

Income or gain of a nonresident alien individual or foreign corporation is treated as effectively connected with a U.S. trade or business if it is attributable to a sale or exchange of property or the performance of services (or any other transaction) in any other taxable year if it would have been so treated if such income or gain had been taken into account in that other year.[43] Thus, deferring the recognition of income until a later taxable year in which the foreign taxpayer is no longer engaged in a U.S. trade or business will not change the manner in which the U.S. taxes that income.

Any income or gain of a foreign person from the sale or exchange of property which was used or held for use in connection with the conduct of a U.S. trade or business, which takes place after the cessation of that trade or business, will be treated as effectively connected with a U.S. trade or business if the sale or exchange of such property occurs within 10 years after such cessation. The income or gain will therefore be taxed as though the sale or exchange had taken place right before ceasing to conduct the U.S. trade or business.[44]

In these two cases, the effectively connected income concept will no longer be applied on a strict annual basis, as was provided by the regulations.

As drafted by the Senate, the removal (*i.e.*, physical departure) of a business asset from U.S. jurisdiction would have been treated as a taxable disposition of those assets. However, this provision was omitted from the final version of the Act. *See* Conference Report, p. II-651.

VII. Tax Free Exchanges of Tax Avoidance Expatriates

A. Introduction

If a U.S. citizen renounces his/her U.S. citizenship and one of the principal purposes of such renunciation is to avoid U.S. Federal income or estate and gift taxes, then for a period of up to 10 years such tax avoidance expatriate is subject to tax under Code §877(b). Tax determined under §877(b), however, applies only if it exceeds the amount of tax that would be payable under §871, *i.e.*, the rules generally applicable to nonresident aliens.[45]

Section 877(b) treats expatriates like resident aliens in that they can neither take advantage of the §871 30% tax rate on U.S. source investment type income nor benefit from the 183-day rule prescribed in §871(a)(2) for U.S. source capital gains. At the same time, §877(b) treats expatriates like nonresident aliens in that they are subject to tax only on U.S. source income (not effectively connected with a U.S. trade or business) and income effectively connected with a U.S. trade or business.[46] Section 877(b) is complemented by §877(c), which provides special source rules for purposes of determining the tax under §877(b). Under §877(c), gain derived from the sale of: (i) property (other than stock or debt obligations) located in the United States; (ii) stock of a domestic corporation, and (iii) debt obligations issued by U.S. persons or Federal, state, or local governments, are U.S. source income regardless of the property source of income rules prescribed in §§861(a)(6) and 862(a)(6).

The impact of Code §877(b), therefore, is to tax expatriates on their U.S. source income on a net basis at graduated rates, regardless of how such income would be taxed to nonresident aliens. Because Code §877(b) subjects tax avoidance expatriates to U.S. tax only on U.S. source income and not on foreign source income, expatriates could escape U.S. tax liability by exchanging U.S. property for foreign property in a tax-free exchange and then selling the foreign property obtained in the exchange. The sale of the U.S. property would have been subject to U.S. tax, whereas the sale of the foreign property obtained in exchange of the U.S. property would not have been subject to tax prior to the 1986 TRA. Congress intended to close this loophole

[40] Regs. §§1.864-3 and 1.864-4 through 1.864-7.
[41] Regs. 1.864-3(a).
[42] House Report at 436; Senate Report at 408.
[43] Code §864(c)(6), as amended by Act §1242.
[44] Code §864(c)(7), as amended by Act §1242.
[45] Code §877(a).
[46] Code §872(b)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

which enabled tax avoidance expatriates to accomplish indirectly what they were prohibited from doing directly.[47]

B. Overview

The gain realized by tax avoidance expatriates from the sale or exchange of property the basis of which is determined in whole or in part by reference to the basis of property located in the U.S. is treated as the gain from the sale of U.S. property.[48]

Amended Code §877(c) applies to sales or exchanges of property received in exchanges after September 25, 1985. Act §1243(b).

C. Detailed Analysis

Section 1243 of the 1986 TRA adds a new sentence at the end of Code §877(c) to provide that, for purposes of that section, gain on the sale or exchange of property which has a basis determined in whole or in part by reference to U.S. property located in the U.S., stock issued by a U.S. corporation or debt obligations of a U.S. person, including Federal, state and local governments, is treated as gain from such U.S. property subject to tax in the U.S.

Note: The 1986 TRA does not prevent tax avoidance expatriates from making tax-free exchanges of U.S. property for foreign property. However, if the expatriate subsequently disposes of the foreign property received in the tax-free exchange, any gain recognized on the disposition will be subject to U.S. tax as if the expatriate had disposed of U.S. property.

VIII. Transfer Prices for Imports

In a number of cases, U.S. taxpayers have paid related foreign entities prices for goods exceeding the value of the property as declared to U.S. customs. Under §482, where one entity is charged by another commonly controlled entity a price for goods in excess of an arm's length price, the IRS is authorized under Regs. §1.482-2(e) to increase the gross income of the entity paying the excessive price to reflect what it would be if an arm's length price had been paid.

The IRS has sometimes taken the position that the basis or inventory value of goods imported by a U.S. entity from a related (in the §482 sense) foreign entity, insofar as it is based on costs taken into account in computing the customs value of the property, should not exceed the latter. This position, however, has seldom been supported by the courts where the U.S. taxpayer has been able to offer other evidence of an arm's length price. Congress decided that the IRS position had sufficient merit to warrant its inclusion in the Code as a specific rule. *See* Conference Report at II-656. Under new §1059A, enacted by 1986 TRA §1248, if any property is imported into the U.S. in a transaction (directly or indirectly) between "related persons (within the meaning of §482) "[49] the amount of any costs which are taken into account both in computing the basis or inventory value of such property and in computing its customs value are not to exceed the amount of such costs taken into account in computing its customs value. This provision is effective as to transactions entered into after March 18, 1986. Act §1248(c).

New §1059A is discussed in greater detail in Chapter 68 which deals primarily with the 1986 Act's amendment to §482 relating to transfers of intangible property.

IX. Treatment of Certain Persons in Panama [Act §1232]

A. Background

On September 7, 1977, the United States and the Republic of Panama signed the Panama Canal Treaty (T.I.A.S. No. 10030), which was ratified by the Senate on April 17, 1978, and took effect on October 1, 1979. Under the Treaty, the Panama Canal Zone is subject to the sovereign jurisdiction of Panama, while the United States retains the right to manage and operate the Canal until the year 2000. The agency operating the Canal on behalf of the United States is the Panama Canal Commission, the employees of which are employees of a U.S. government agency.[50] Under an agreement implementing Article III of the Panama Canal Treaty (Implementation Agreement T.I.A.S. No. 10031) there is the statement that "United States citizen employees and dependents shall be exempt from any taxes, fees, or other charges on income received as a result of their work for the Commission." Because of this statement, many U.S. employees of the Commission have taken the position that their salaries are exempt from both United States and Panamanian income taxation.[51]

Several of these taxpayers have sought refunds of U.S. taxes paid on Panama Canal Commission salaries. In *Copeland v. United States*,[52] the Court of Appeals for the Federal Circuit held that the Implementation Agreement did not exempt U.S. citizens from U.S. taxation on such salaries. In the Eleventh Circuit, however, the appeals court determined that such income was exempt from U.S. taxation.[53] In making its determination, the court stated that the "plain language" of the Treaty required a complete exemption from all taxes.

Certain U.S. government employees stationed abroad, not including those of the Panama Canal Commission, are permitted to exclude from gross income certain housing, cost of living and other allowances under Code §912. These exclusions are granted under specifically enumerated statutory provisions such as the Foreign Service Act of 1980.[54] In 1984, Congress amended the Panama Canal Act to allow the Defense Department to grant quarters allowances to its

[47] House Report at 438; Senate Report at 410.

[48] Code §877(c), as amended by §1243 of the Act.

[49] This is the language of the statute. Actually, §482 does not refer to "related" persons, but organizations which are controlled by the same interests.

[50] *See* 22 USCA §3611, 3612 (1986 Supp.), and Panama Canal Treaty Article III, §3, T.I.A.S. No. 10030.

[51] *See* Code §894(a) which states that "[i]ncome of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle."

[52] 761 F.2d 688 (Fed. Cir. 1985).

[53] *See Harris v. Comr.*, 768 F.2d 1240 (11th Cir. 1985).

[54] *See, e.g.*, §912(1)(a).

employees in Panama, but §912 was not amended to cover such allowances.[55]

B. Detailed Analysis

Section 1232 of the Tax Reform Act of 1986 adds a non-Code rule which states that nothing in the Panama Canal Treaty, or in any implementing agreement, shall be construed as exempting any citizen or resident of the United States from any U.S. income tax. In addition, employees of the Panama Canal Commission and civilian employees of the Department of Defense stationed in Panama will be permitted to exclude from their gross income allowances which are comparable to the allowances excludible under §912(1) of the Code by employees of the State Department of the United States stationed in Panama.

Shortly after the enactment of the Tax Reform Act change, the Supreme Court issued its decision in *O'Connor v. United States*,[56] in which it held that the exemption from taxes granted by the Implementation Agreement to the Panama Canal Treaty applied only to Panamanian taxes and not to U.S. taxes. Hence, citizens of the United States employed by the Panama Canal Commission who had filed refund claims on the theory that such agreement exempted such income from U.S. taxes were denied refunds. The Supreme Court noted that the treaty had been consistently applied by the Executive Branch and that the Panama Canal Commission had consistently withheld U.S. income taxes from the petitioners and others similarly situated. The Court did not rely in its decision on the Tax Reform Act of 1986, although that Act, as explained below, was retroactive for all taxable years whether beginning before, on or after the date of enactment.

C. Effective Dates

The amendment subjecting all income of U.S. persons employed by the Panama Canal Commission in Panama to U.S. income taxation applies, as explained above, retroactively to all taxable years whether beginning or, before or after the date of enactment of the Tax Reform Act of 1986.[57] Although the provision is retroactive, the recent decision of the Supreme Court in *O'Connor v. United States*, which concerned refund claims dating back to the year in which the Panama Canal Treaty took effect (1979), may, as a result of its interpretation of the Treaty, avoid the constitutional question relative to retroactive income taxation which might otherwise be posed by the Act.[58]

Despite the fact that the foregoing amendment subjecting all income of U.S. persons employed by the Panama Canal Commission to U.S. taxation is retroactive, the amendment providing that allowances paid to such persons are excludible under §912(1) of the Internal Revenue Code is effective only in taxable years beginning after December 31, 1986.

[55] *See* Senate Report at 386.
[56] 55 U.S.L.W. 4007 (Nov. 4, 1986).
[57] *See* Act §1232(a) and (b).
[58] *See United States v. Darusmont*, 449 U.S. 292, 296-301 (1981); and *Welch v. Henry*, 305 U.S. 134, 146-151 (1938) cited in *O'Connor v. U.S.*, 55 U.S.L.W. 4007 (Nov. 4, 1986).

X. Study of U.S. Reinsurance Industry

A. Introduction

An excise tax is imposed on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer with respect to U.S. risks.[59] The policies covered are those to or for or in the name of a U.S. corporation or partnership, or a U.S. resident individual with respect to risks wholly or partly within the U.S. or to or for or in the name of any foreign person engaged in business within the U.S. with respect to risks within the U.S.[60]

The excise tax is imposed at varying rates, as follows: (1) Four cents on each dollar of premiums charged on casualty insurance and indemnity bonds; (2) one cent on each dollar of premiums charged on life insurance, sickness and accident policies and on annuity contracts; and (3) one cent on each dollar of premiums charged on policies of reinsurance of contracts taxable under (1) or (2) above.[61] The tax is collected by return.[62]

Exemptions are provided under the Code in the case of any policy, indemnity bond, or annuity contract signed or countersigned by an officer or agent of the insurer in a State, territory or the District of Columbia in which such insurer is authorized to do business, or any indemnity bond required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the U.S., or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-saving certificate, warrant or check issued by the U.S.[63]

Furthermore, a number of recent U.S. tax treaties, such as the treaties with Barbados, Cyprus, France and the United Kingdom, contain provisions which may waive imposition of the excise tax on payments to some insurers and reinsurers.

Although premiums received by certain persons may be exempt from the excise tax (whether by treaty or by statutory exception), such exceptions generally do not waive the excise tax for subsequent reinsurance transactions covering insurance of U.S. risks under which premiums are paid to and received by a nonexempt person. *See* Senate Report at 411.

The excise tax is imposed on foreign reinsurers only to the extent that they are not subject to U.S. income tax. Foreign reinsurers generally are subject to U.S. income tax on income derived from the reinsurance of U.S. risks if that income is effectively connected with the conduct of a U.S. trade or business. *See* Senate Report at 410. A foreign reinsurer of U.S. risks ordinarily will not be viewed as conducting a U.S. trade or business and will therefore not be subject to U.S. income tax, unless the foreign reinsurer has a U.S. office or agent in the U.S. *See id.* Tax treaties may further limit the circumstances in which foreign reinsurers are subject to U.S. income tax. By contrast, U.S.

[59] Code §4371.
[60] Code §4372(d).
[61] Code §4371.
[62] Code §4374.
[63] Code §4373.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

reinsurers, like other U.S. persons, are generally subject to U.S. tax on worldwide income on a net basis.

The Senate Report expressed its concern that U.S. reinsurers may be at a competitive disadvantage vis-a-vis foreign reinsurers of U.S. risks as a result of the disparate income tax treatment of U.S. and foreign reinsurers. Furthermore, the excise tax on insurance premiums paid to foreign insurers, which should mitigate these inequities in certain cases, is frequently not imposed on foreign insurers because of exemptions under tax treaties.[64]

B. Overview

The Secretary of the Treasury is to study the effect that existing tax treaties have on domestic reinsurance corporations and whether these are placed at a significant competitive disadvantage vis-a-vis foreign reinsurance corporations. The Secretary must report the results of the study to the Senate Finance Committee and the House Ways and Means Committee before January 1, 1988.[65]

C. Detailed Analysis

The study to be conducted by the Secretary or his delegate must consider the provisions of existing tax treaties between the U.S. and other countries and must specifically identify those treaties which create a significant competitive disadvantage on U.S. reinsurance corporations. The Senate Report indicates that if the study concludes that U.S. reinsurance corporations are at such a competitive disadvantage, the Secretary should renegotiate the relevant treaties to eliminate that disadvantage.[66]

As originally drafted, the House bill proposed to amend the present excise tax system of imposing one tax on the direct insurance of a U.S. risk and another tax on the reinsurance of a U.S. risk, to ensure that an excise tax would be collected in all events to the extent that a U.S. risk was being insured, whether directly or indirectly, by a foreign insurer that was not subject to U.S. income tax or otherwise exempt from the excise tax.[67] The tax would have been levied by withholding and the tax rate differentiation would have been eliminated. The House bill's provisions were very similar to provisions included in the Senate version of the Tax Reform Act of 1984 which were subsequently deleted in conference. *See* House Report at 440-41. These amendments were again deleted in conference and are not part of the text of the 1986 TRA as finally enacted.

---

[64] Senate Report at 411.
[65] §1244 of the 1986 TRA.
[66] Senate Report at 411-412.
[67] House Report at 440.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 72

TECHNICAL CORRECTIONS TO THE FOREIGN PROVISIONS

Deborah M. Beers, Esq.
Silverstein and Mullens
Washington, D.C.

The Tax Reform Act of 1986 [1] contains numerous technical, clerical and conforming amendments to the Tax Reform Act of 1984 [2] affecting the foreign tax provisions of the Code. These amendments, outlined below, are to take effect as if included in the provisions of the Tax Reform Act of 1984, except as otherwise provided.[3]

I. Maintaining the Source of Income [Act §1810(a)]

A. Background

Over the years, U.S. taxpayers with excess foreign tax credits have devised a number of techniques for absorbing the excess credits. One popular technique is the conversion of U.S. source income into low taxed foreign source dividend income by utilizing a foreign tax haven corporation.

The dividend source of income rules are contained in Code §§861 and 862. As a general rule, the source of dividend income is governed by the payor's place of incorporation. Thus, dividends paid by a corporation incorporated in the United States (excluding possessions) are U.S. source income,[4] and dividends paid by a corporation incorporated outside the 50 States and the District of Columbia are foreign source income.[5] There are, however, a number of exceptions to this general rule. (*See* Chapter 61, *supra*) For example, interest and dividends paid by a domestic corporation that earns less than 20% of its gross income from U.S. sources over a three-year period (an "80/20 company") are foreign source under Pre-TRA 1986 Code §§861(a)(1)(B) and 861(a)(2)(A). Therefore, under the Code, a U.S. taxpayer can convert U.S. source income into foreign source income by routing it through a 80/20 company, as long as the company's U.S. source gross income remains below the 20% threshold.[6]

B. The Tax Reform Act of 1984

The Tax Reform Act of 1984 (P.L. 98-369) added to the foreign tax credit rules under §904, new rules which recharacterized as U.S. source income the Subpart F income, the undistributed foreign personal holding company income, the foreign source dividend income, and the foreign source interest income derived from a 50% U.S.-owned foreign corporation to the extent such inclusions in the income of U.S. shareholders are attributable or allocable to U.S. source income of the foreign corporation. The recharacterization rule applies for purposes of §904 only, and, for all other purposes of the Code, the income retains its foreign source character.

In the case of dividend or interest income derived from a U.S.-owned foreign corporation, however, §904(g)(5), as amended by the Tax Reform Act of 1984, provides a *de minimis* exception. According to this exception, foreign source dividends or interest derived from a U.S.-owned foreign corporation are not recharacterized as U.S. source income if: (i) the foreign corporation has earnings and profits for the relevant taxable year, and (ii) less than ten percent of such earnings and profits is attributable to U.S. sources.

The 1984 Act contained several transition rules,[7] one of which provided that "qualified interest" shall not be taken into account under §904(g), and, hence, will escape recharacterization as U.S. source income if received or accrued by an "applicable CFC" [8] before January 1, 1992. "Qualified interest" [9] is defined to include interest received or accrued by an applicable CFC during any taxable year on "United States affiliate obligations" [10] held by an applicable CFC multiplied by a limiting fraction. The limiting fraction is equal to the aggregate principal amount of U.S. affiliate obligations held by the CFC on March 31, 1984 (but not in excess of the applicable limit, *i.e.*, the CFC's capitalization on March 31, 1984) [11] divided by the average daily principal amount of U.S. affiliate obligations held by the applicable CFC during the taxable year. In no event may the limiting fraction exceed one.

An "applicable CFC" is any CFC which was in existence on March 31, 1984, the principal purpose of which was the issuance of CFC obligations and the holding of short-term obligations and lending the proceeds of such obligations to affiliates.[12]

A "United States affiliate obligation" is any obligation of a U.S. person related (within the meaning of Code §482) to an applicable CFC holding the obligation. Interest paid on an obligation of a foreign person is not subject to the source maintenance rules.[13]

C. Technical Corrections

Section 1810(a) of the Tax Reform Act of 1986 (P.L. 99-514) amends §121 of the Tax Reform Act of 1984 (P.L. 98-369) to provide that an 80/20 company will be treated as a U.S.-owned foreign corporation, subject to the rules

[1] P.L. 99-514, 99th Cong., 2d Sess. (Oct 22, 1986).
[2] P.L. 98-369, 98th Cong., 2d Sess. (July 18, 1984).
[3] P.L. 99-514, *supra* §1881.
[4] §861(a)(2).
[5] §862(a)(2).
[6] *See* S. Rep. No. 313, 99th Cong., 2d Sess., 934 (1986) ("Senate Report").
[7] P.L. 98-369, §121(b)(2).
[8] *Id.*, §121(b)(2)(D).
[9] *Id.*, §121(b)(2)(B).
[10] *Id.*, §121(b)(2)(F).
[11] *Id.*, §121(b)(2)(I).
[12] *Id.*, §121(b)(2)(D).
[13] *See* Senate Report at 934.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

maintaining the source of U.S. income, thus preventing U.S. taxpayers from using 80/20 companies to convert U.S. source income to foreign income.[14] The amendment with respect to the 80/20 companies is to take effect on March 28, 1985.[15] However, in the case of any taxable year of an 80/20 company ending after March 28, 1985, only income received or accrued by the 80/20 company during that portion of the taxable year after that date generally will be taken into account for purposes of the new source maintenance rules. For purposes of the ten percent *de minimis* exception added to §904(g)(5) by the Tax Reform Act of 1984, however, all income received or accrued by the 80/20 company during the taxable year is to be taken into account.[16]

Section 1810(a)(2) of the 1986 Act amends §121(b)(2) of the 1984 Act by providing that certain U.S. source interest paid to an applicable CFC by an affiliated corporation on an obligation of that corporation issued before March 31, 1984 will be subject to the resourcing provisions to the same extent that interest so paid by an affiliated U.S. corporation would be so subject. This rule is available only if at least 50% of the foreign corporation's gross income for the three-year period ending on or before March 31, 1984, and with the close of its taxable preceding the payment of the interest in question, was effectively connected with U.S. trade or business.

Section 1810(a)(3) of the 1986 Act amends §121(b)(2)(D) of the 1984 Act (defining "applicable CFC") by including in that term any CFC in existence on March 31, 1984, the principal purpose of which on that date consisted of (1) issuing CFC obligations and shortterm borrowing *from non-affiliated persons*, and (2) lending the proceeds to affiliates.

In addition to the foregoing, the 1986 Act, §1810(a)(4), makes clear that the source maintenance rules apply notwithstanding any contrary U.S. treaty obligation, even if entered into after the effective date of the 1986 Act (October 22, 1986), unless the treaty expresses a clear intent to override the rules by specific reference to them.[17]

II. Maintaining the Character of Income [Act §1810(b)]

A. Introduction

Since many foreign countries do not impose any income tax on interest income earned by foreigners, a U.S. taxpayer might consider generating foreign source income, and thus utilizing its excess foreign tax credits, by exporting cash to such a foreign country and earning interest income on it. This possibility, however, is foreclosed by §904(d), which provides for a separate §904 limitation on all foreign source interest income. This limitation was greatly expanded in the Tax Reform Act of 1986.[18] Because of §904(d), foreign taxes imposed on non-interest income do not offset U.S. tax that applies to low-tax foreign source interest income.

Prior to the enactment of the Tax Reform Act of 1984 (P.L. 98-369), however, a U.S. person might circumvent the §904(d) separate limitation on interest income in at least two ways. First, a U.S. person might create a foreign corporation and lend money through such corporation to borrowers resident in countries which impose little or no income tax on interest paid to foreigners. The interest income earned by the foreign corporation would generally be included in the gross income of U.S. shareholders currently as a dividend either under the foreign personal holding company provisions (§§551-558) or the Subpart F provisions (§§951-964) of the Code. This simple technique, therefore, enabled a U.S. taxpayer to convert potential interest income into dividend income. Second, a U.S. person might buy shares in a U.S. corporation (*i.e.*, a mutual fund) which invests in foreign securities, the interest income from which bears little or no foreign tax. If the U.S. corporation earns more than 80% of its gross income from foreign sources, the dividends received by the U.S. person from such corporation would be characterized as foreign source income.[19]

B. Tax Reform Act of 1984

Cognizant of this manipulation of the character of income, Congress enacted §122 of the Tax Reform Act of 1984 adding a new "look-through rule" in §904(d)(3) which provides for the maintenance of the character of income as interest (which is subject to a separate limitation) when such income is earned through a foreign corporation or a regulated investment company and distributed (whether actually or constructively) to the U.S. shareholders as dividends or interest. Under the general rule of §904(d)(3), as amended by the Tax Reform Act of 1984, when a "designated payor corporation" (50% or more U.S.-owned foreign corporation, regulated investment company, or a foreign corporation in which the taxpayer is a ten percent U.S. shareholder) pays or accrues dividends or interest, such payments are treated as interest (subject to the separate limitation) in the hands of the U.S. recipients, but only to the extent that the payor corporation's earnings and profits for the relevant taxable year include separate limitation interest. Under a *de minimis* exception contained in the 1984 Act, however, if the designated payor corporation has earnings and profits for a particular taxable year and the separate limitation interest is less than ten percent of such earnings and profits, dividends and interest paid or accrued by such corporation are not recharacterized as interest which is subject to the separate §904(d)(2) limitation.

The types of payments made or accrued by a designated payor corporation which are recharacterized as interest under the 1984 Act are: (i) interest;[20] (ii) constructive dividends under §551 (undistributed foreign personal holding income);[21] (iii) constructive dividends under §951 (Subpart F income and certain other income);[22] (iv) §1246 gain (gain derived by U.S. stockholders on the sale or exchange of stock in a foreign investment company);[23] and (v) §1248

[14] *See* P.L. 99-514, §1810(a)(1)(A).
[15] P.L. 99-514, §1810(a)(1)(B).
[16] *Id.*
[17] *See* Senate Report at 935.
[18] P.L. 99-514 §1201.
[19] §861(a)(2)(A).
[20] §904(d)(3)(A).
[21] §904(d)(3)(H)(i).
[22] *Id.*
[23] §904(d)(3)(H)(ii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

dividend (gain recognized on the sale or exchange of stock of a controlled foreign corporation by a ten percent U.S. person).[24]

Under the 1984 Act, interest received by a designated payor corporation from another corporation (whether domestic or foreign) which is a member of the same affiliated group within the meaning of §1504, is not separate limitation interest unless such interest is attributable directly or indirectly to the separate limitation interest of the designated payor corporation.[25]

The 1984 Act also eliminated an exception previously available at the shareholder level for interest earned on investments of working capital. Since regulated investment companies earn primarily passive investment income, their income generally cannot qualify for the working capital exception, and dividends paid by such companies generally are treated as interest subject to the separate limitation (to the extent that the regulated investment company earns separate limitation interest) whether the recipient shareholder's investment is one of working capital or not.[26]

C. *Technical Corrections*

The Tax Reform Act of 1986 amends §122 of the Tax Reform Act of 1984 as follows:

First, §1810(b)(1) of the 1986 Act provides that the 1984 Act *de minimis* rule does not apply to prevent the maintenance of the character of interest income which is includible in the gross income of shareholders of a foreign corporation under §551 (foreign personal holding companies) or §951 (controlled foreign corporations).

Next, §1810(b)(2) of the 1986 Act clarifies that when a designated payor corporation receives dividends or interest from another member of the same affiliated group (within the meaning of §1504), that amount shall be treated as separate limitation interest if (and only if) the amount is attributable (directly or indirectly) to separate limitation interest of *any other member* of the group (not just the payor corporation).

Third, the Act provides that dividends and interest received by a shareholder that owns directly or indirectly less than ten percent of the voting stock of a regulated investment company will not be treated as interest subject to the separate limitation for interest if derived from any transaction which is directly related to the active conduct by the shareholder of a trade or business in a foreign country or U.S. possession.[27]

Fourth, and finally, the Act clarifies the definition of "designated payor corporation" to include any other corporation formed or availed of for purposes of avoiding (through structuring the ownership of a corporation in such a manner as to place that corporation technically outside the present law definition of designated payor corporation) the recharacterization rules.[28] Thus, U.S. taxpayers will not be permitted, in violation of the purpose of the look-through rule, to convert interest income to non-interest income by earning that income through a foreign banking subsidiary or similar entity formed or availed of for that purpose which, absent the anti-abuse rule, would not be subject to the separate foreign tax credit limitation for interest by reason of being earned in the conduct of a similar banking business.[29]

The 1986 Act also expands the definition of designated payor corporation to include any 80/20 company,[30] an amendment designed to prevent U.S. taxpayers from using 80/20 companies to circumvent the separate foreign tax credit for interest income.[31]

D. *Effective Dates*

The anti-avoidance amendment to the definition of designated payor corporation generally takes effect on December 31, 1985.[32] The amendment expanding the definition of designated payor corporation to include any 80/20 company takes effect generally on March 28, 1985 except that for any taxable year of a corporation treated as a designated payor corporation ending after the indicated date, only income received or accrued by the corporation during that portion of the taxable year after that date generally is to be taken into account for purposes of the look-through rule. However, all income received or accrued by the corporation during that taxable year is to be taken into account in determining whether the ten percent *de minimis* exception applies. The legislative history states that a corporation formed on or before December 31, 1985, but availed of after that date to avoid the look-through rule, will be subject to the rule.[33]

III. Related Party Factoring Income [Act §1810(c)]

A. *Introduction*

When goods or services are sold on credit, the seller generally takes from the purchaser a receivable, which is a transferable promise to pay cash in the future. The seller may cash the receivable prior to its maturity date by selling it to a third party, a "factor" (*i.e.*, a finance company), at a discount. The seller's income realized from the sale of goods or services in such a case is reduced by the amount of the discount. When the receivable is paid, the factor realizes income in the amount of the discount.

Prior to the passage of the Tax Reform Act of 1984, the practice of factoring by foreign subsidiaries of trade accounts receivable of U.S. parent companies (and of U.S. and foreign affiliates) was very popular. In employing this technique, the U.S. multinational companies hope to achieve numerous tax advantages including the repatriation of untaxed foreign earnings accumulated abroad by a controlled foreign corporation ("CFC") and the shifting of a portion of the income (*i.e.*, equal to the discount income) earned by the U.S. parent (or a foreign affiliate) from a sale of goods or services out of the United States (or high tax foreign) taxing jurisdiction to a low or zero tax jurisdiction. Among the tax issues involved in the typical factoring

[24] *Id.*
[25] §904(d)(3)(J).
[26] Senate Report at 937.
[27] P.L. 99-514, §1810(b)(3).
[28] P.L. 99-514, §1810(b)(4)(A).
[29] *See* Senate Report at 938.
[30] P.L. 99-514, §1810(b)(4)(A)(second sentence).
[31] *See* Senate Report at 938.
[32] P.L. 99-514, §810(b)(4)(B)(ii).
[33] Senate Report at 938.

arrangement was the treatment of the purchase by the foreign factoring company of the trade accounts receivable of its U.S. parent and other U.S. affiliates as a potential investment in U.S. property under §956 of the Code.

Under §956, any U.S. shareholder of a CFC was taxed currently on its pro rata share of the increase in the taxable year of the CFC's earnings in "United States property." The term "United States property", as defined in §956(b)(1), includes "an obligation of a U.S. person." Section 956(b)(2)(F), however, provides that the term "United States property" does not include the obligation of an unrelated U.S. corporation. Since, in a typical factoring arrangement, the foreign factoring subsidiary factored the obligations of unrelated U.S. (and foreign) corporations, the U.S. parent of the subsidiary had no potential exposure under §956.

B. Tax Reform Act of 1984

Section 123 of the Tax Reform Act of 1984 (P.L. 98-369) added a new paragraph (3) to subsection (b) of §956 and a new subsection (d) to §864. Section 956(b)(3) provides a strict rule that treats the trade accounts receivable acquired from related U.S. parties under which the obligor is a U.S. person as "United States property" for purposes of §956(a). Consequently, U.S. taxpayers are not able to repatriate untaxed foreign earnings from investments in such receivables tax-free. Section 864(d) insures that the discount income earned by the foreign factoring subsidiary is taxed currently to the U.S. shareholders of the subsidiary under either the foreign personal holding company provisions of the Code (§§551-558) or under the Subpart F provisions of the Code (§§951(a)(1), 952(a)(2) and 954(c)).

The provision in §956(b)(3) overrode the exceptions to the investment in U.S. property rules, including the exclusion from U.S. property of an amount of assets equal to post-1962 earnings and profits previously excluded from Subpart F income, on the ground that the United States already had subjected those amounts to tax directly as effectively connected income.[34] Under §864(d), moreover, discount income earned by a foreign factoring subsidiary would be currently taxable even when the receivable was acquired from an entity that was organized under the laws of the same country as the acquirer, and that had a substantial part of its assets used in its trade or business located in that same country.[35]

In addition to the foregoing, under the 1984 Act, related person factoring income is treated as interest described in §904(d)(2), subject to the separate foreign tax credit limitation for interest under that section. Section 904(d)(3)(J), however, contains an exception to this treatment of related person factoring income treated as interest where such interest was received or accrued by a designated payor corporation from another member of the same affiliated group (unless such interest was attributable directly or indirectly to separate limitation interest of such member).

[34] §956(b)(2)(H).
[35] *See* Senate Report at 939.

C. Technical Corrections

1. Investment in U.S. Property

The Tax Reform Act of 1986 amendments to §123 of the 1984 Act[36] provide that the existing exclusion from U.S. property of an amount of assets equal to the controlled foreign corporation's post-1962 earnings and profits excluded from Subpart F income under §952(b)[37] will apply to the acquisition of a trade or service receivable that otherwise constitutes U.S. property.

2. Current Inclusion of Factoring Income

The 1986 Act applies the "same country" exception to factoring income where a related person acquires a factored receivable from an entity that is organized under the laws of the same foreign country as the acquirer, and that has a substantial part of its assets used in its trade or business located in that same country.[38] This exception does not apply, however, where the person transferring the receivable would have derived any foreign base company income (without regard to the 20% *de minimis* exception) or income effectively connected with a U.S. trade or business, had it collected the receivable.[39]

3. Separate Limitation Treatment

Section 1810(c)(3) of the 1986 Act amends §864(d)(5)(A) to require that related person factoring income treated under the Act as interest (although exempt from current inclusion in income by reason of the amendments to §864(d)) is nevertheless subject to the separate limitation for interest without regard to the exception to the definition of separate limitation interest for interest received from members of the same affiliated group (Code §904(d)(3)(J)).

IV. Repeal of Withholding Tax on Portfolio Interest [Act §1810(d)]

A. Introduction

Prior to the Tax Reform Act of 1984, the United States imposed a flat 30% tax (subject to reduction under an applicable tax treaty provisions) on the gross amount of U.S. source income (*e.g.*, dividends, interest, rents and royalties) and certain other income (*e.g.*, OID, gains described in §§402(a)(2) and 403(a)(2)) derived by a nonresident alien individual or a foreign corporation, provided such income was not effectively connected with a U.S. trade or business of such individual or corporation.[40] This 30% tax is generally collected by withholding at the source by the person making the payment (*i.e.*, the withholding agent) and, therefore, is referred to as the "30% withholding tax."[41]

B. Tax Reform Act of 1984

The 1984 Act repealed the 30% tax with respect to (1) portfolio interest paid on obligations issued in registered form for which the U.S. payor (or U.S. person whose duty

[36] P.L. 99-514, §1810(c).
[37] §956(b)(2)(H).
[38] P.L. 99-514, §1810(c)(2), amending Code §864(d).
[39] For examples, *see* Senate Report at 940.
[40] §§871(a) and 881(a).
[41] §§1441 and 1442.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

it would otherwise be to withhold the tax) received a statement that the beneficial owner of the obligation was not a U.S. person [42] and (2) portfolio interest received by a controlled foreign corporation ("CFC") from a person other than a related person. (Section 881(c)(4), however, provides rules which effectively insure that such interest will be taxed currently in the hands of the CFC's U.S. shareholders.)

The 1984 repeal of the 30% withholding tax with respect to U.S. source investment income did not apply to interest paid to foreign persons having a direct ownership interest (ten percent or greater) in the U.S. payor.[43] In determining whether the ten percent or greater ownership exists, the stock attribution rules of §318(a) of the Code apply. Under one of these rules, a corporation generally is deemed to own stock that its 50% or greater owned subsidiary owns in proportion to the corporation's share of its subsidiary stock.[44] Similarly, a 50% or greater owned subsidiary generally will be deemed to own the stock that its parent owns.[45] In determining whether direct ownership exists for purposes of the repeal of the withholding tax, the first of these rules is applied without regard to the 50% limitation, but the second is not.[46] Thus, an affiliated group of corporations may circumvent the direct ownership exception to the 30% tax repeal by having a U.S. member pay interest to an affiliated foreign corporation that is as much as 49% owned by a substantial foreign shareholder in the U.S. member, rather than directly to that substantial shareholder.[47]

C. *Technical Corrections*

Section 1810(d)(3) of the 1986 Act amends §871(h)(2)(B)(ii) and §881(c)(2)(B)(ii) to clarify that the beneficial owner of a registered obligation under that section may claim a refund of any tax withheld where the required non-U.S. person statement is provided after, rather than before, one or more interest payments are made. Claims for such refunds are to be subject to the general statute of limitations rules for refund claims contained in §6511.[48]

TRA 1986 also amends the definition of portfolio interest to exclude interest that would not have been subject to the 30% tax prior to the 1984 Act.[49] Thus, interest received by CFCs will be eligible for any otherwise applicable Subpart F exceptions unless such interest would have been subject to the 30% tax in the absence of the repeal.[50]

The 1986 Act [51] also amends Code §871(h)(3)(C) by adding a new subsection which provides that, in determining whether direct ownership exists for purposes of the repeal, §318(a)(3)(C) (relating to attribution of stock owned by the parent of a 50% or greater owned subsidiary) is to be applied without regard to the 50% ownership limitation. In applying this rule, however, the foreign interest recipient is treated as owning the stock that its foreign shareholders own in proportion to that shareholder's ownership interest in the foreign interest recipient.[52]

V. OID Income and Deduction for Foreign Persons [Act §1810(e)]

A. *Introduction*

Under §1273(a)(1) of the Code the term "original issue discount" ("OID") means, with respect to any obligation, the excess (if any) of such obligations "stated redemption price at maturity" over its "issue price." Under the rules generally applicable to OID instruments, if OID exists, the holder of the obligation will be required to include in income an amount equal to the sum of the daily portions of the OID for each day during the taxable year in which the obligation is held.[53] Similarly, the obligor may deduct, under §163(e) of the Code, the aggregate daily portion of the OID that accrues during the taxable year. However, because an accrual method obligor on an OID instrument held by a foreign investor is entitled to deduct the OID periodically during the life of the instrument while the foreign investor, under §§871(a)(1)(C) and 881(a)(3), recognizes OID income only upon the payment of any stated interest or upon the sale, exchange or retirement of the instrument, the issuance or sale of OID instruments to foreign investors prior to the Tax Reform Act of 1984 resulted in a mismatching of OID income and deductions that worked to the disadvantage of the government.

B. *Tax Reform Act of 1984*

In the Tax Reform Act of 1984 (P.L. 98-369), Congress added to the provisions of the Act relating to OID derived by foreign investors a new rule delaying the obligor's deduction for OID accrued but not paid with respect to an OID instrument held by a related foreign person until the time of actual payment. In effect, the provision put accrual method taxpayers on the cash method for purposes of determining the interest deduction for OID on instruments held by related foreign persons.[54] The term "related foreign person" is defined as any person (1) that is not a United States person, and (2) that is related to the issuer within the meaning of §267(b).[55]

Under the Tax Reform Act of 1984, the term "interest" as it appears in §§871(a)(1)(A) and 881(a)(1) of the Code (governing the U.S. tax treatment of income derived by non-resident aliens and foreign corporations from U.S. sources), does not include OID (as defined in §1273), so that the taxation of OID is governed exclusively by the specific rules contained in Code §§871(a)(1)(C) and 881(a)(3). These sections impose a 30% withholding tax on U.S. source OID that is not effectively connected with a U.S. business and that accrues on an obligation while such obligation is held by a non-resident alien or foreign corporation. If the obligation is interest-bearing, accrued OID is

[42] §871(h)(2)(B).
[43] §871(h)(3).
[44] §318(a)(2)(C).
[45] §318(a)(3)(C).
[46] §871(h)(3)(C)(i).
[47] Senate Report at 942.
[48] Senate Report at 942.
[49] *See* P.L. 99-514, §1810(d)(1)(A) and (B).
[50] *See* Senate Report at 942.
[51] §1810(d)(2).
[52] §871(h)(3)(C)(ii)(II); Senate Report at 942.
[53] §1272.
[54] §163(e)(3).
[55] §163(e)(3)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

subject to U.S. withholding tax at the time interest is paid. Otherwise OID is subject to tax at the time the obligation is sold, exchanged or retired. In the case of a taxable interest payment on an OID obligation, a foreign investor is taxable on an amount equal to the OID accrued on the obligation since the last payment of interest thereon. In the case of the sale, exchange or retirement of the OID obligation, the foreign investor is taxable on the amount of any gain not in excess of the OID accruing while the foreign investor held the obligation (to the extent not previously taxed).[56]

C. *Technical Corrections*

Section 1810(e)(1) of the Tax Reform Act of 1986 amends §163(e) of the Code to provide that the rule delaying the obligor's deduction for OID accrued but not paid with respect to an OID instrument held by a related foreign person does not apply to the extent that the OID income is effectively connected with the lender's conduct of a U.S. trade or business, unless such OID is exempt from tax (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

The 1986 Act also amends §§871(a)(1)(C) and 881(a)(3) to provide that when a foreign investor receives a payment on an OID obligation the amount taxable is equal to the OID accrued on the obligation that has not previously been taxed, whether or not such OID accrued since the last payment of interest. Similarly, if the OID instrument is sold, exchanged or retired, the foreign investor is taxable on the previously untaxed amount of the OID accruing while the foreign investor held the obligation, whether or not such amount exceeds the foreign investor's gain on the transaction.[57]

VI. Amendments to FIRPTA [Act §1810(f)]

A. *Introduction*

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") generally taxes the gains realized by non-resident aliens and foreign corporations upon the disposition of U.S. real property interests. Prior to the enactment of FIRPTA, tax on the disposition of a U.S. real property interest would have been imposed only if the gain were effectively connected with a U.S. trade or business, or, in the case of non-resident alien individuals, the seller was present in the U.S. for 183 days or more during a taxable year.

U.S. real property interests include certain holdings in U.S. real property holding corporations ("U.S. RPHC").[58] As defined in §897(c)(2), a "U.S. RPHC" is any corporation (whether foreign or domestic) the fair market value of whose U.S. real property interests is at least 50% of the sum of the fair market value of its U.S. real property interests, its interest in foreign real property, and its interest in any other assets used in a trade or business during the taxable year.[59] Any interest in a domestic corporation, other than an interest solely as a creditor, is treated as a U.S. real property interest unless the taxpayer establishes that the corporation was at no time a U.S. RPHC during the period after June 18, 1980, during which the taxpayer held the interest, or the five-year period preceding the disposition of the interest, whichever is shorter (the "test period").[60]

B. *Tax Reform Act of 1984*

Prior to the Tax Reform Act of 1984, Congress envisioned relying on information reporting requirements to enforce FIRPTA provisions. The Tax Reform Act of 1984 added new §1445 to the Code, which requires any transferee to withhold tax on the disposition of a U.S. real property interest (as defined in §897(c)) by a foreign person. The normal withholding rate under §1445 is ten percent of the amount realized on the disposition.

Under §1445(b), no withholding is required if one of five exemptions applies to a transaction. First, a transferee will be relieved of any withholding obligation if the transferor furnishes to the transferee an affidavit by the transferor stating, under penalty of perjury, (1) that the transferor is not a foreign person and (2) the transferor's U.S. taxpayer identification number ("non-foreign affidavit"). Second, no withholding will be required upon the disposition of an interest in a domestic corporation if the domestic corporation furnishes to the transferee an affidavit stating, under penalty of perjury, that the domestic corporation is not and has not been a U.S. RPHC during the test period specified in §897(c)(1)(A)(ii). Third, a transaction is exempt from withholding if the transferee of a U.S. real property interest receives a "qualifying statement" from the IRS that either the transferor is exempt from tax under FIRPTA, the transferor or the transferee has provided adequate security for payment of the tax, or the transferor or the transferee has made other arrangements for the payment of the tax. Fourth, a transferee who acquires property for use by him as a residence will not be required to withhold FIRPTA tax if the total purchase price of the property does not exceed $300,000. Fifth, no withholding is required on a disposition of shares of a class of stock that is regularly traded on an established securities market.

Under §1445(b)(7), a transferor's agent or a transferee's agent who has actual knowledge that a non-foreign affidavit or an affidavit that a domestic corporation is not a U.S. RPHC is false, but fails to notify the transferee that the affidavit is false, may be liable for withholding to the extent of the agent's compensation derived from the transaction. In the case of a transferor's agent whose principal is a foreign corporation, the agent will be liable to the extent of his compensation for failure to notify the transferee that the transferor's affidavit is false, even in the absence of actual knowledge on the part of the agent.

The 1984 Act provided several special rules relating to corporations, partnerships, trusts and estates. A domestic or foreign partnership, trust or estate must withhold tax equal to ten percent of the fair market value of any U.S. real property interest distributed to a foreign partner or beneficiary if the distribution is subject to FIRPTA tax.[61] The transferee of an interest in a partnership, trust or estate

[56] §§871(a)(1)(C) and 881(a)(3).
[57] P.L. 99-514, §1810(e)(2).
[58] §897(c)(1)(A)(ii).
[59] §897(c)(2).
[60] §897(c)(1)(A)(ii).
[61] §897(g).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

also may be required to withhold tax equal to ten percent of the amount realized by the transferor on the disposition of an interest in the partnership, trust or estate. A domestic partnership, the trustee of a domestic trust, or the executor of a domestic estate must withhold tax equal to ten percent of any amount in its custody that is attributable to the disposition of a U.S. real property interest and is includible in the income of a foreign partner or beneficiary. A foreign corporation is required to withhold tax equal to 28% of the amount of net gain recognized on a distribution to shareholders under §§897(d) or 897(e). If a domestic corporation that is or has been a U.S. RPHC during the test period specified in §897(c)(1)(A)(ii) redeems stock from a foreign shareholder in a transaction taxable under §302 or makes a liquidating distribution to a foreign shareholder, the corporation must withhold tax equal to ten percent of the amount realized by the foreign shareholder.

If a foreign corporation holds a U.S. real property interest, and under any treaty obligation of the U.S. is entitled to nondiscriminatory treatment with respect to that interest, then the foreign corporation may elect to be treated as a U.S. corporation for purposes of FIRPTA substantive and reporting provisions.[62] This election is not available, however, with respect to the withholding requirements of §1445.

The Tax Reform Act of 1984 generally repealed the information reporting requirements of FIRPTA. However, it amended §6039C to authorize the IRS to prescribe regulations requiring reporting by foreign persons holding direct investments in U.S. real property interests. A foreign person will be treated as holding a direct investment in U.S. real property interests if the foreign person did not engage in a trade or business in the U.S. at any time during the calendar year and the foreign person directly held, at any time during the calendar year, U.S. real property interests with a fair market value of at least $50,000.

C. Technical Corrections

The Tax Reform Act of 1986 [63] makes numerous technical and conforming amendments to the FIRPTA provisions as follows:

1. Election To Be Treated As A Domestic Corporation

The 1986 Act amends §897(i) of the Code to provide that foreign corporations electing to be treated as domestic corporations for purposes of FIRPTA substantive and reporting provisions may also elect to be treated as a domestic corporation for withholding purposes. Thus, electing foreign corporations may provide non-foreign affidavits. The reason for this amendment, as stated in the Senate Report [64] is that, since enactment of the 1984 Act, the IRS has developed a procedure, pursuant to regulations, that would provide U.S. buyers with reasonable assurance that a non-foreign affidavit received from a foreign corporation is valid.[65]

2. Withholding Exemptions for Transfers of Stock in Certain Domestic Corporations

Section 1810(f)(2) of the 1986 Act amends paragraph (3) of §1445(b) (relating to non-publicly traded domestic corporations furnishing affidavit that it is not a U.S. RPHC) to provide that withholding is not required on the disposition of an interest (other than an interest solely as a creditor) in a non-publicly traded domestic corporation if the corporation furnishes an affidavit to the transferee stating under penalties of perjury either (1) that the domestic corporation is not and has not been a U.S. RPHC during the test period specified in §897(c)(1)(A)(ii) or (2) that as of the date of the disposition, interests in the corporation are not U.S. real property interests by reason of §897(c)(1)(B). Under that section, interests in a corporation are not U.S. real property interests if the corporation is not holding any U.S. real property interests at the time of disposition and if the corporation disposed of all U.S. real property interests held during the test period described in §897(c)(1)(A)(ii) in transactions in which the element of gain was recognized.[66]

3. Foreign Corporate Transferors — Notice-Giving and Withholding Responsibilities of Agents

As noted above, agents of a transferor foreign corporation are liable under the 1984 Act to the extent of their compensation for failure to notify the transferee that the transferor's non-foreign affidavit is false, even in the absence of proof of actual knowledge on the part of the agent. Section 1810(f)(3) of the 1986 Act clarifies, through amendment to §1445(d)(1)(B) of the Code, that the agent of a foreign corporate transferor of a domestic corporation's stock will not be charged with actual knowledge of the falsity of a false non-U.S. real property interest affidavit furnished by the domestic corporation in the absence of such knowledge.[67] The agent of a foreign corporate transferor will be charged with knowledge of the falsity only of a false non-foreign affidavit furnished by his or her principal.

4. Treatment of Certain Domestic Partnerships, Trusts and Estates

Section 1810(f)(4) of the 1986 Act amends §1445(e)(1) of the Code to provide that a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate is to withhold a tax equal to 28% of the gain realized on the disposition by the entity of a U.S. real property interest to the extent that such gain is allocable to a foreign person who is a partner or beneficiary of such partnership, trust or estate, or is allocable to a portion of the trust treated as owned by a foreign person under the grantor trust rules of Subchapter J.

The Senate Report states that withholding liability under this special rule is not limited to the gain realized on the disposition that is in custody of the partnership, trustee or executor, although a partnership, trustee or executor that does not have sufficient sales proceeds to satisfy its withholding liability from the proceeds in its custody may request a qualifying statement from the IRS authorizing it to withhold the lesser amount.[68] The Senate Report notes, however, that withholding on the basis of gain is feasible in

[62] §897(i).
[63] P.L. 99-514, §1810(f).
[64] Senate Report at 944.
[65] *See* Temp. Regs. §§1.1445-2T(b)(2)(ii), 1.1445-5T(b)(3)(ii)(C), and 1.1445-7T(a).
[66] *See* Senate Report at 947.
[67] *See* Senate Report at 947.
[68] *Id.* at 948.

this case because, unlike the buyer in the usual withholding situation (who may not know the seller's basis) the withholding agent under §1445 — a partnership, trustee or executor — knows what the foreign taxpayer's gain on the disposition will be since the agent itself must compute the amount of that gain.[69]

The 28% withholding rate reflects the maximum 28% capital gains rate for corporations prior to the abolition of the rate differential between ordinary income and capital gains.[70] The corporate capital gains rate under TRA 86 generally is 34%.[71]

There is a special effective date applicable to the treatment of domestic partnerships, trusts and estates. Modifications to these provisions will be effective for dispositions of U.S. real property interests beginning after the day 30 days after the date of enactment (October 22, 1986).[72]

5. *Distributions by U.S. RPHCs to Foreign Shareholders*

Under the 1984 Act, as noted above, if a domestic corporation is or has been a U.S. RPHC during the test period specified in §897(c)(1)(A)(ii), and such corporation redeems stock from a foreign shareholder in a transaction taxable under §302 or makes a liquidating distribution to a foreign shareholder, it must withhold tax equal to ten percent of the amount realized by the foreign shareholder. The 1986 Act clarifies that no withholding is required on certain liquidations and redemptions that are not taxed under the substantive FIRPTA rules.[73] Thus, no withholding will be required on a corporate liquidation or redemption when interests in the corporation are not U.S. real property interests by reason of Code §897(c)(1)(B) on the date of distribution. This section excludes from the definition of U.S. real property interests interests in a corporation that (1) is not holding U.S. real property interests at the time the corporate interest is disposed of, and (2) disposed of all U.S. real property interests held during the §897(c)(1)(A)(ii) test period in transactions in which the full amount of gain was recognized.[74]

6. *Taxable Distributions by Partnerships, Trustees and Executors*

Section 1810(f)(5) of the 1986 Act amends paragraph (4) of §1445(e) to clarify that a distribution to a foreign person of a U.S. real property interest by a domestic or foreign partnership, trustee or executor is subject to withholding if such distribution is taxable under *any* of the substantive FIRPTA rules, not just Code §897(g).

7. *Miscellaneous*

The 1986 Act[75] amends the penalty provisions (Code §6652(g)) that govern failure to provide FIRPTA information returns to conform with the revised information reporting rules of the 1984 Act which limited the circumstances under which the Secretary could require information reporting.

The Act[76] also clarifies that persons required to withhold tax under the FIRPTA withholding rules, like persons having substantive FIRPTA tax liability, are to pay the tax to and file the necessary returns with either the U.S. or the Virgin Islands, depending upon the location of the real property interest involved.[77]

VII. Outbound Transfers Under §367 [Act §1810(g)]

A. *Introduction*

Subchapter C of the Code (specifically §§332, 351, 354, 355, 356 and 361) provides for non-recognition of gain to a transferor of assets or stock in connection with certain exchanges involving the organization, reorganization or liquidation of a corporation. However, where such an exchange involves the transfer by a U.S. person to a foreign corporation (*i.e.*, a so-called "outbound" transfer), §367(a) of the Code may deny such non-recognition treatment by denying corporate status to the foreign transferee. Prior to amendments made by the Tax Reform Act of 1984, non-recognition treatment was generally denied under §367(a)(1) in respect of such outbound transfers unless the U.S. transferor timely requested and obtained a ruling from the Internal Revenue Service to the effect that the transfer did not have a principal tax avoidance purpose.

B. *Tax Reform Act of 1984*

In the Tax Reform Act of 1984, the tax avoidance purpose standard and the ruling requirement were eliminated. Instead, under the 1984 Act, gain generally must be recognized on a transfer of appreciated property to a foreign corporation pursuant to one of the "tax-free" exchanges described in §367(a). The principal exception to this general "automatic toll charge" rule is for transferred property that will be used by the transferee in the "active conduct of a trade or business outside the United States."[78]

The 1984 Act also added Code §367(e) pursuant to which a domestic corporation must recognize gain under §336 on a liquidating distribution of appreciated property to any foreign person (not just corporate transferees) under rules similar to those applicable to transfers to foreign corporations. Although the applicability of §355 (distribution of stock or securities of controlled corporations) also does not depend upon whether the distributee is a corporation, §367(e) did not include a provision requiring recognition of gain by a U.S. transferor with respect to distributions to foreign persons pursuant to Code §355.[79] Instead, such distributions were subject to §367 only if made to a foreign corporate shareholder under the general rule of §367(a).

C. *Technical Corrections*

The Tax Reform Act of 1986, §1810(g)(3)(B), amends §367(e) to provide that transfers of stock by domestic corporations to foreign persons pursuant to Code §355 will

[69] *Id.*
[70] *Id. See* P.L. 99-514, §311, and Code §1201.
[71] §1201.
[72] P.L. 99-514 §1810(f)(4)(B).
[73] Senate Report at 949.
[74] *Id.*
[75] P.L. 99-514, §1810(f)(9).
[76] P.L. 99-514, §1810(f)(7).
[77] Senate Report at 949.
[78] §367(a)(3)(A).
[79] *See* Senate Report at 950.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

give rise to recognition of gain under §367(e) to the extent provided in regulations. The 1986 Act thus provides the statutory basis for including §355 distributions of stock or securities to non-corporate foreign shareholders within the general rule of §367. The effective date of this change is for transfers or exchanges after 12/31/84, in taxable years ending after that date. *See* 1986 Act §1810(g)(4)(B) and 1984 Act §131(g).

Note: Amended §367(e) does not apply to the treatment of distributions described in §336 since, under the 1986 Act,[80] the general rule of §336 was changed to provide that gain or loss is recognized by a liquidating corporation on a distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.[81] Under the 1986 Act, §631(d)(1), Code §367(e) covers distributions of stock pursuant to §355 and, (effective generally for liquidating distributions after July 31, 1986, unless the corporation is completely liquidated before January 1, 1986—*see* 1986 Act §633(a)) distributions in liquidations under §332 (where the 80% distributee is a foreign corporation).

VIII. Amendments to FPHC Rules [Act §1810(h)]

A. Introduction

Section 551(a) of the Code requires a U.S. shareholder of a foreign personal holding company ("FPHC") to include in his gross income his proportionate share of the FPHC's "undistributed foreign personal holding company income." An FPHC is defined by reference to both a gross income requirement and a stock ownership requirement.[82] Under the gross income requirement, at least 50% of the gross income of the FPHC (60% initially) must be "foreign personal holding company income" (as defined in §553). Such income generally will encompass income from passive investments such as interest, dividends, rents and royalties. Under the stock ownership requirement of §552(a)(2)(as amended by the 1986 Act), more than 50% in the value of the outstanding stock of the corporation or more than 50% of the voting power of all classes of stock entitled to vote must be owned by five or fewer individuals who are citizens or residents of the U.S.

B. Tax Reform Act of 1984

1. Same Country Dividend and Interest Rule

Section 552(c) of the Code, added by §132(c)(2) of the Tax Reform Act of 1984 [83] excepts from the definition of both gross income and foreign personal holding company income any dividends and interest which are described in §954(c)(4)(A) of the controlled foreign corporation ("CFC") rules and which are received from a related person which is not a foreign personal holding company. Dividends or interest described in §954(c)(4)(A) include dividends and interest received from a related person created or organized under the laws of the same foreign country as the CFC, which had a substantial part of its assets used in its trade or business located in that same foreign country. The 1984 Act did not define the term "related person" for purposes of §552(c).

2. Stock Held Through a Foreign Entity

Prior to the Tax Reform Act of 1984, the "United States shareholders" required to include the undistributed foreign personal holding income of the FPHC in their gross incomes included only those individuals or entities which actually owned stock in the FPHC. Therefore, a U.S. person could avoid the requirement of inclusion of undistributed foreign personal holding company income in income by interposing a foreign partnership, foreign operating corporation (other than an FPHC) or a foreign estate or trust between the U.S. person and the FPHC. Section 132(b) of the Tax Reform Act of 1984 amended §551 of the Code by redesignating subsection (f) as subsection (g) and by adding a new subsection (f) to provide that stock of an FPHC owned by a foreign partnership, estate or trust or by a foreign corporation which is not a foreign personal holding company is considered to be owned proportionately by its partners, beneficiaries or shareholders.

C. Technical Corrections

1. Same Country Dividend and Interest Exception

The Tax Reform Act of 1986, §1810(h)(1), amends §552(c) to adopt, for purposes of that section, the definition of "related person" contained in §954(d)(3) of the Code (except that for purposes of §552, the term "foreign personal holding company" is substituted for the term "controlled foreign corporation"). This provision is effective for taxable years of foreign corporations beginning after March 15, 1984. *See* 1986 Act §1881 and 1984 Act §132(d)(2)(B).

Note: The 1986 TRA, §1221(e)(1) amended §954(d)(3), effective, pursuant to 1986 TRA §1221(g)(1), for taxable years of foreign corporations beginning after December 31, 1986. Therefore, presumably, the 1986 TRA version of §954(d)(3) is used for §552(c) purposes for taxable years beginning after December 31, 1986, and the the 1984 TRA version of §954(d)(3) is used for §552(c) purposes for taxable years beginning after March 15, 1984, but before January 1, 1987.

Under §954(d)(3), as amended by the 1986 TRA, §1221(e)(1), a person is a related person with respect to an FPHC if the person is (1) an individual who controls the FPHC or a corporation, partnership, trust or estate which controls or is controlled by the FPHC; or (2) a corporation, partnership, trust, or estate controlled by the same person or persons which control the FPHC. "Control" of a corporation means the direct, indirect and constructive ownership of stock possessing 50% or more of the total combined voting power of all classes of stock entitled to vote or 50% or more of the value of the stock. "Control" of a partnership, trust, or estate means the direct, indirect and constructive ownership of 50% or more (by value) of the beneficial interests in partnership, trust, or estate.

Under §954(d)(3), prior to amendment by the 1986 TRA, a person is a related person with respect to a FPHC if the person is (1) an individual, partnership, trust, or estate which controls the FPHC; (2) a corporation which controls or is controlled by the FPHC; or (3) a corporation which is controlled by the same person or persons which

[80] P.L. 99-514, §631(a).
[81] §336(a).
[82] §552(a)(1) and (2).
[83] P.L. 98-369.

control the FPHC. "Control" means the direct, indirect and constructive ownership of stock possessing more than 50% of the total combined voting power of all classes of voting stock.

2. Stock Held Through Foreign Entity

The Tax Reform Act of 1986 clarifies that under §551(f), the tracing rule applies to *all* foreign trusts and estates interposed between U.S. taxpayers and FPHCs.[84] This provision applies generally to taxable years of foreign corporations beginning after December 31, 1986. *See* 1986 TRA §1881 and 1984 TRA §132(d)(1).

IX. Amendments to Code §1248(i) [Act §1810(i)]

A. Introduction

Under §1248(a) of the Code, gain recognized upon the sale or exchange of stock in a controlled foreign corporation ("CFC") by a U.S. shareholder (a U.S. person who owns directly, indirectly or constructively at least ten percent of the total combined voting power of all voting stock) is included in gross income of such U.S. shareholder as a dividend to the extent of the earnings of the CFC accumulated in post-1962 years during the period the stock was held by the U.S. shareholder. The purpose of §1248 is to prevent U.S. taxpayers from accumulating earnings free of U.S. tax in a CFC and then disposing of the stock at capital gains rates for a price that reflects the accumulated earnings and profits (which would be taxable as ordinary income if repatriated as dividends).

B. Tax Reform Act of 1984

Section 133(a) of the Tax Reform Act of 1984 (P.L. 98-369) added a new subsection (i) to §1248 which was designed to eliminate a specific technique utilized by certain taxpayers to avoid §1248. The technique involved the acquisition of a widely-owned U.S. parent's stock by a CFC in exchange for its own shares and small amounts of cash. Section 1248(i) provides that, for purposes of §1248, where any shareholder of a U.S. corporation which is a ten percent or more corporate shareholder in a foreign corporation exchanges stock in a U.S. corporation for stock in the foreign corporation, the foreign corporation's stock will be treated as if it has been issued to the ten percent U.S. corporate shareholder and then distributed to the exchanging shareholder of such ten percent corporate shareholder in redemption of his stock. The term "ten percent corporate shareholder" means any domestic corporation which, as of the day before the exchange, satisfied the stock ownership requirements of §1248(a)(2).[85]

Thus, under §1248(i), when U.S. shareholders of a U.S. corporation exchange stock in the U.S. corporation for newly issued or Treasury stock of the foreign corporation in which the U.S. corporation is a ten percent or more owner, the transaction will be recast. For purposes of applying §1248, the foreign corporation will be viewed as having issued the stock to the U.S. corporation and the U.S. corporation will be treated as having distributed that stock to its U.S. shareholders in redemption of their stock. Under §1248, the U.S. corporation, therefore, would be required to recognize dividend income equal to the difference between the fair market value of the stock received by the shareholders of the U.S. corporation and the U.S. corporation's basis for its stock in the foreign corporation, to the extent of the foreign corporation's post-1962 accumulated earnings and profits.

Section 133(b) of the Tax Reform Act of 1984 also added a new subsection (e) to §959 and a new subsection (j) to §1248 which, taken together, provide that whenever a U.S. shareholder sells or exchanges stock in a CFC (or a U.S. corporate shareholder sells or exchanges the CFC stock in a §311, §336 or §337 transaction) and recognizes gain which is characterized as ordinary dividend income under §1248(a) (or §1248(f)), then any subsequent distribution of earnings and profits previously taxed as a §1248(a) or §1248(f) dividend to the selling or exchanging shareholder's successor in interest will be tax-free. Taxpayers were given an election to apply this provision retroactively to transactions occurring after October 9, 1975.[86]

C. Technical Corrections

Section 1810(i) of the Tax Reform Act of 1986 amends §133 of the Tax Reform Act of 1984 to provide that whenever, under Code §1248(i), an indirect transfer is recast, it may be recast either as a distribution, redemption or liquidation, whichever is appropriate.[87] This provision applies to exchanges after July 18, 1984, in taxable years ending after that date. *See* 1986 TRA §1881 and 1984 TRA §133(d)(1).

The 1986 Act also extends the period during which the election relating to previously taxed earnings can be made until one year after enactment of the Technical Corrections provisions.[88]

X. Stapled Stock Provisions of §269B Amended [Act §1810(j)]

A. Introduction

"Stapled stock" transactions have in the past provided a unique opportunity to decontrol certain foreign corporations where control of a corporation by U.S. persons may have a significant impact on the tax liability of the controlled corporation and its shareholders. In a "stapled stock" transaction, stock of a foreign subsidiary of a U.S. corporation is distributed pro rata to the shareholders of the U.S. parent and then paired or "stapled" to the stock of the parent by restricting the transfer of the stock of one corporation without the transfer of the stock of the other. In some cases, the stock certificates of the stapled entities are printed on both sides of a single document. If stock ownership of the domestic U.S. parent corporation is sufficiently widely-held, then the pro rata distribution of the stock of the foreign subsidiary to the shareholders of the U.S. parent will in most cases avoid the concentration of control in a few U.S. shareholders which is necessary for the corporation to be treated as a foreign personal holding company (FPHC) or controlled foreign corporation (CFC).

[84] *See* Senate Report at 951.
[85] §1248(i)(2).
[86] P.L. 98-369, §133(d)(3)(A).
[87] P.L. 99-514, §1810(i)(1).
[88] P.L. 99-514, §1810(i)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. Tax Reform Act of 1984

The Tax Reform Act of 1984 added a new §269B ("stapled entities") to the Code, pursuant to which, if a domestic and foreign corporation are stapled entities, the foreign corporation will be treated as a domestic corporation, subject to U.S. taxation on its worldwide income.[89] A "stapled entity" is *any* group (whether or not owned by U.S. persons) of two or more entities if more than 50% in value of the beneficial ownership in each consists of stapled interests (*i.e.*, an interest which is subject to transfer in connection with the interest to which it is stapled).

Section 269B(b) directs the Secretary to prescribe regulations necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities, including regulations providing the extent to which one of such entities is to be treated as owning the other entity (to the extent of the stapled interests).[90] Under the 1984 Act, however, the regulations to be prescribed need not specify how the tax to be imposed on the "stapled" foreign entity is to be collected.

C. Technical Corrections

Section 1810(j) of the 1986 Act amends subsection (b) of §269B to direct the Secretary to prescribe regulations providing that any tax imposed on the stapled foreign corporation, if not paid by such corporation, may be collected from the domestic corporation to which it stapled or from the shareholders of such foreign corporation.

The Tax Reform Act of 1986 also limits the stapled entity rules, so that a foreign corporation will not be treated as a domestic corporation, where it is established to the satisfaction of the Secretary of the Treasury that both the stapled foreign corporation and the U.S. corporation to which it is stapled are foreign-owned. §269B(e)(1). For this purpose, a corporation is considered to be foreign-owned if less than 50% of the total combined voting power of all classes of stock entitled to vote and the total value of the stock of a corporation is held directly or indirectly by U.S. persons.[91] This amendment is consistent with the purpose of §269B, which is to prevent avoidance of tax rules applicable to U.S.-controlled corporations,[92] not foreign-controlled corporations.

Note: A corporation may be a controlled foreign corporation within the meaning of §957(a) of the Code only if *United States shareholders* (*i.e.*, those U.S. persons who own ten percent or more of the total combined voting power of the voting stock of the foreign corporation) [93] own *more than 50%* of the voting power or value of the stock of the foreign corporation. Under §269B(e) of the Code as added by the 1986 Act, however, a foreign corporation may be subject to the rules on stapled stock if U.S. persons (who may own less than ten percent of the voting power of the foreign corporation) own *50% or more* of the voting power or value of the foreign corporation or the domestic corporation to which it is stapled.[94]

[89] §269B(a)(1).
[90] §269B(b).
[91] §269B(e)(2).
[92] *See* Senate Report at 953.
[93] §951(b).
[94] §269B(e)(2) and 7701(a)(30).

XI. Foreign Base Company Services Income Provisions Clarified [Act §1810(k)]

A. Introduction

Under §957(a) of the Code, as amended by the Tax Reform Act of 1986, any foreign corporation of which more than 50% of the total combined voting power of all classes of stock entitled to vote or of which more than 50% of the value is owned, actually or constructively, by U.S. shareholders (generally those shareholders with a ten percent or greater interest in the voting stock of the corporation) on any day during the taxable year of such foreign corporation will be a "controlled foreign corporation" ("CFC"). U.S. shareholders of a CFC are required to include in gross income their pro rata share of certain types of income of the CFC including the CFC's "Subpart F" income. The term "Subpart F income" includes, among other things, the "foreign base company services income" of a CFC.[95]

Under §954(e) of the Code the term "foreign base company services income" means income (whether in the form of compensation, commissions, fees or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services which (1) are performed for or on behalf of any related person within the meaning of §954(d)(3) (essentially a 50% control test),[96] and (2) are performed outside the country under the laws of which the CFC is created or organized.[97] The first of these requirements may be referred to as the "related person" test, and the second as the "foreign performance" test.

Although the performance of insurance services for a 50% related person would satisfy the first, or related person, test, the place of performance of services, under Treasury regulations interpreting the second, or foreign performance, test, is generally where the person performing the services is physically located when performing his duties.[98] Since insurance personnel employed by a CFC would customarily be physically located in the country of organization of the CFC, the practical effect of this rule, prior to the Tax Reform Act of 1984, was that the foreign performance condition of §954(e)(2) would seldom be satisfied for insurance services, and thus the income derived from the performance of such services for a related party was largely immunized from current taxation.

B. Tax Reform Act of 1984

Section 137 of the Tax Reform Act of 1984 amended §954(e) of the Code by adding, at the end thereof, a sentence stating that, for purposes of the foreign performance test of §954(e)(2), services performed with respect to a policy of insurance with respect to which the primary insured is a "related person" will be treated as having been

[95] §954(a)(3).
[96] For taxable years of foreign corporations beginning on or before December 31, 1986 "control" of a corporation means ownership of more than 50% of the voting power of the corporation. For taxable years of foreign corporations beginning after December 31, 1986, "control" means ownership of 50% or more of the voting power or value of the foreign corporation. P.L. 99-514, §1221(e) and (g).
[97] §954(e)(1) and (2).
[98] Regs. §1.954-4(c).

performed in the country within which the risk of loss against which the related person is insured is located. Thus, the effect of the physical location rule of the regulations is nullified in the case of insurance services. The term "related person," as it applies to the 1984 amendment, has the same meaning as it has in §864(d), where a ten percent or more ownership interest causes two parties to be related.

The purpose of expanding the scope of the term "related person" was "to impose tax on an insurance company owned (directly or indirectly) by a relatively small number of U.S. shareholders that use it in whole or in part to insure their foreign risks or foreign risks of parties related to them." [99] This purpose was not achieved, however, because the narrower meaning of "related person" given in Code §954(d)(3) (which uses a 50% test) was retained in the 1984 Act for purposes of the related party test of §954(e)(1). Since services must satisfy both the related party and foreign performance tests in order for the income therefrom to be "foreign base company services income," income from services performed in insuring the foreign risks of a ten percent affiliate of a CFC or its parent, where those risks are located outside the country of organization of the CFC, are not technically "foreign base company services income." Although such services satisfy the foreign performance test of §954(e), since they would be deemed to be performed outside the CFC's country of organization under the sentence added by the 1984 Act to Code §954(e), they would not satisfy the related party test.

C. Technical Corrections

The Tax Reform Act of 1986 amends §954(e) of the Code to provide that, in applying the rule that treats income from services performed with respect to insurance or reinsurance for or on behalf of related persons as "foreign base company services income," the primary insured will be treated as a related person if it is related within the meaning of §864(d)(4) of the Code — the rule that reaches ten percent U.S. shareholders and persons related to them.[100] This rule applies to taxable years of CFCs beginning after July 18, 1984. *See* 1986 Act §1881 and 1984 Act §137(b).

XII. Amendments to the Definition of a Resident Alien [Act §1810(l)]

A. Introduction

The United States applies a special tax regime to non-resident alien individuals. For example, a non-resident alien individual not engaged in a U.S. trade or business is subject to tax at a flat 30% rate, collected by withholding at the source [101] on the gross amounts of U.S. source fixed or determinable, annual or periodical (FDAP) income,[102] and certain other types of income.[103] A non-resident alien individual engaged in a U.S. trade or business, who does not maintain an office in the United States, is subject to U.S. tax at graduated rates on the net amounts of all U.S. source income [104] except the amounts described in §871(a), which are not effectively connected with the alien's U.S. trade or business.[105] If a non-resident alien individual, who is engaged in a U.S. trade or business, maintains an office in the United States, specific categories of such individual's foreign source income are also treated as income effectively connected with the U.S. trade or business and, thus, fall within the U.S. tax net.[106]

Resident alien individuals on the other hand, are taxed by the United States at graduated rates applicable to U.S. citizens on net income derived from U.S. as well as foreign sources. Due to the differences in the tax regimes applicable to resident and non-resident alien individuals, the amount of U.S. tax liability varies under the two regimes depending upon the income mix (both as to source and type of income) of the individual. Thus, under one set of facts, the tax regime applicable to non-resident alien individuals may yield a lower U.S. tax while, under a different set of facts, the tax regime applicable to resident alien individuals may yield a lower U.S. tax. Consequently, an alien may desire to be classified as "resident" or a "non-resident" alien of the United States depending upon which regime yields a lower U.S. tax. However, while the concept of "residence" occupies a highly significant place in the U.S. tax scheme applicable to aliens, the term "residence" was not defined anywhere in the Code prior to the Tax Reform Act of 1984.

B. Tax Reform Act of 1984

Section 138 of the Tax Reform Act of 1984 (P.L. 98-369), inserted Code §7701(b) to provide, for the first time, a statutory definition of the term "resident." Under §7701(b), as added by the 1984 TRA, an alien individual is treated as a resident of the United States for a calendar year if such individual satisfies either of the following two tests:

1. The alien is a lawful permanent resident of the United States under the immigration laws at any time during the calendar year (*i.e.*, the green card test);[107] or

2. The alien satisfies the "substantial presence" test.[108]

Under the substantial presence test, an alien individual who was present in the U.S. on at least 31 days of the calendar year generally will be treated as a resident of the United States for a calendar year in either of the two following situations:[109]

> (i) The alien is physically present in the United States for 183 days or more during the calendar year; or
>
> (ii) The sum of the following equals or exceeds 183 days: (A) the number of days the alien is physically present in the United States during the current calendar year, plus (B) one-third of the number of days the alien is physically present in the United States during the first preceding calendar year, plus (C) one-sixth of the number of days the alien is physically present in the

[99] H.R. Rep. No. 861, 98th Cong., 2d Sess. 965-966 (1984).
[100] P.L. 99-841, §1810(k). Senate Report at 954.
[101] §§871(a)(1) and 1441(a).
[102] §871(a)(1)(A).
[103] §§871(a)(1)(B), (C) and (D).
[104] §§871(b), 864(c)(1), (2) and (3).
[105] Such income remains subject to the withholding tax at a rate of 30% (or the lower treaty rate) unless exempt under the Code or applicable treaty.
[106] §864(c)(4).
[107] §7701(b)(1)(A)(i).
[108] §7701(b)(1)(A)(ii).
[109] §7701(b)(3)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

United States during the second preceding calendar year.

For purposes of the "substantial presence" test, an alien individual's presence in the United States in the following capacities is disregarded:

(i) As a foreign government-related individual (A-visa and G-visa holders);[110]

(ii) As a teacher or trainee (but only up to a maximum of two years);[111]

(iii) As a student (but only up to a maximum of five years);[112]

(iv) By reason of a medical condition which arose while the alien was present in the U.S.;[113] and

(v) As a commuter from Mexico or Canada.[114]

Finally, §7701(b) does not override U.S. tax treaties. Consequently, if an alien individual is treated as a resident of a foreign country under the tie-breaking rules of a U.S. tax treaty, such individual is a non-resident alien of the United States under §7701(b), but only for purposes of applying the treaty provisions.

C. Technical Corrections

Section 1810(l) of the Tax Reform Act of 1986 amends §138 of the Tax Reform Act of 1984 (§7701(b) of the Code) to increase the exemption period for teachers and trainees from two years to a maximum of four calendar years. Under revised §7701(b)(5)(E)(i), days spent working in the United States as a teacher or trainee during four calendar years in any seven calendar year period do not count as days of U.S. presence for purposes of the substantial presence test if all of the individual's compensation is described in Code §872(b)(3) (relating to compensation of participants in certain exchange or training programs). *See* Senate Report at 955. This provision applies generally to taxable years beginning after 1984. *See* 1986 TRA §1881 and 1984 TRA §138(b)(1)-(3).

The Act also permits certain individuals to elect to be treated as a U.S. resident in a calendar year ("the election year") in which the individual is not otherwise treated as a U.S. resident, if the individual meets the "substantial presence" test for the following calendar year. Revised Code §7701(b)(4). In order to qualify for the election the alien individual (1) must not be a resident of the United States in the year preceding the election year; (2) must be present in the United States for at least 31 consecutive days in the election year; and (3) must be present in the United States during the period beginning with the first day of the 31-day presence and ending with the last day of the election year for a number of days equal to or exceeding 75% of the number of days in such period. In applying this test, an individual will be treated as present in the United States for up to five days during which he or she actually was absent from the country.[115] Under §7701(b)(4)(C), an alien individual making the election will be treated as a U.S. resident only for that portion of the election year which begins on the first day of the earliest presence period for which the individual can satisfy both the 31-day and 75% tests. For purposes of both such tests, an individual will not be treated as present in the United States in any day during which such individual is (i) a foreign government-related individual; (ii) a teacher or trainee; (iii) a student; or (iv) a professional athlete who is temporarily in the United States to compete in certain charitable sports events.[116]

The election to be treated as a U.S. resident during a calendar year must be made on the qualifying alien individual's tax return for the election year, but may not be made before the individual has met the "substantial presence" test for the calendar year following the election year. Once an election is made it remains in effect for the election year unless revoked with the consent of the IRS.[117]

The Senate Report contains the following example of the operation of the election provision:

> "An alien individual vacations in the United States from January 1 through January 31, 1986. He returns to the United States on October 15, 1986, and begins working on a permanent basis for a U.S. company on that day. For the remainder of 1986, he is absent from the country for ten days only, from December 20 through December 29. He satisfies the substantial presence test in 1987. He was not a U.S. resident in 1985.
>
> "The individual may elect to be treated as a U.S. resident for 1986 under the new provision. His residency starting date is October 15, 1986, because that is the first day of the earliest period in 1986 for which both the 31-day and 75% tests are satisfied. (The 75% test is not satisfied with respect to the presence period commencing on January 1, 1986)." [118]

This provision applies generally to taxable years beginning after 1986. *See* 1986 TRA §1881 and 1984 TRA §138(b)(1)-(3).

XIII. Technical Amendments to the FSC Provisions [Act §1876]

A. Introduction

The 1986 TRA contains numerous technical amendments to both the Foreign Sales Corporation (FSC) and interest charge Domestic International Sales Corporation (DISC) provisions enacted by the Tax Reform Act of 1984.[119] The following discussion highlights some of the more important changes and clarifications which are included in the 1986 Act. Since the conference agreement follows the Senate version of H.R. 3838,[120] the legislative history is derived from the Senate Report. These technical corrections are generally effective as if included in the provision of the 1984 Act to which the amendment relates.[121]

---

[110] §§7701(b)(3)(D) and 7701(b)(4)(A)(i).
[111] §§7701(b)(3)(D); 7701(b)(4)(A)(ii); and 7701(b)(4)(E)(i).
[112] §§7701(b)(3)(D); 7701(b)(4)(A)(iii); and 7701(b)(4)(E)(ii).
[113] §7701(b)(3)(D)(ii).
[114] §7701(b)(6)(B).
[115] P.L. 99-514, §1810(l)(4); Senate Report at 955.
[116] §7701(b)(4)(D) as amended by P.L. 99-514, §1810(l)(5)(A). *See* §7701(b)(5)(A).
[117] §7701(b)(4)(E) and (F).
[118] Senate Report at 956.
[119] P.L. 98-369.
[120] *See* H.R. Rep. 841, 99th Cong., 2d Sess. II-846 (1985) (the Conference Report to P.L. 99-514).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. Foreign Sales Corporations

1. Clarification of Corporate Preference Reductions

The 1986 Act clarifies that, in the case of a corporate shareholder, the cutback of corporate preferences under Code §291 (when calculating the exempt portion of the foreign trade income of an FSC) applies at the FSC level instead of the shareholder level.[122] This clarification is intended to reflect Congress' original intention [123] that the reduction occur at the FSC level in order to reduce the portion of the FSC's foreign trade income which is exempt from tax at the FSC level. Moreover, in cases in which all of the stock in an FSC is not held by one or more C corporations throughout the taxable year, the Service is granted regulatory authority to require proper adjustments in the application of the FSC level cutback to take into account stock held by persons other than C corporations.[124] Thus, where ownership of the FSC is composed of both regular corporations and other persons, Treasury may issue regulations to adjust the portion of exempt foreign trade income between the various rates.

2. Dividends Received Deduction for Certain Distributions Out of Earnings and Profits

A United States corporation, under pre-1986 TRA law, receives a 100 percent dividends-received deduction with respect to those dividends which are distributed out of earnings and profits attributable to the foreign trade income of the distributing FSC.[125] As amended by the 1986 Act, §245 provides for an 85% dividends-received deduction for distributions out of earnings and profits which are attributable to "qualified interest and carrying charges" received or accrued by the distributing FSC.[126] For this purpose, the term "qualified interest and carrying charges" is defined as "any interest or carrying charges (as defined in §927(d)(1)) derived from a transaction which results in foreign trade income." [127] However, the Senate Report indicates that passive income which is not directly related to foreign trade income is not eligible for the dividends-received deduction treatment.[128]

The 100% and 85% dividends-received deductions described above are in lieu of the deductions which are allowable under Code §245(a) and (b). §245(c)(1), last sentence. This coordination of deductions is accomplished by excluding gross income giving rise to earnings and profits with respect to which a dividends-received deduction is allowed under §245(c) when making the dividends-received deduction under §§245(a) and (b). §245(c)(3). For example, gross income from the qualified interest and carrying charges of an FSC will not be taken into account in determining whether a dividend attributable to other FSC income allows a dividends-received deduction because half or more of the FSC's gross income is effectively connected with a United States trade or business.[129] Finally, no dividends-received deduction under §245(c) is permitted with respect to the FSC's non-exempt income. §245(c)(2). Under Code §923(a)(2), non-exempt income is that amount of foreign trade income which does not qualify for the 32% exemption where administrative pricing rules do not apply.

The distributions from an FSC (or former FSC) out of earnings and profits which are attributable to qualified interest and carrying charges are also made subject to a separate foreign tax credit limitation by the 1986 Act.[130] Thus, the imposition of a full United States tax at two levels on that type of income is eliminated, in response to practitioners' concerns over the treatment of FSC carrying charges. In addition, the provision is designed to prevent such income from absorbing foreign tax credits from other income and to prevent other income from absorbing foreign tax credits, if any are allowable, on such income.[131]

3. Exchange of Information Requirements

The special rules contained in Code §927(e) which relate to the exchange of information requirements for a host country of a FSC are amended to create a requirement that there currently be a bilateral (or multilateral) agreement or income tax treaty between the host country and the United States.[132] Thus, if the foreign nation in which the FSC is incorporated ceased to qualify as a host country for FSCs, the corporation could not continue to qualify for FSC status. However, the Senate Report indicates that, under Treasury regulations, such corporations may continue to be eligible for FSC benefits for a six month grace period following the determination that the host country has ceased to qualify.[133]

Section 927(e) is also amended to clarify that, regardless of whether a corporation is eligible to be a beneficiary of the Caribbean Basin Initiative (CBI), a country may qualify as a host country by entering into an agreement on the exchange of information which is similar to that qualifying under the CBI.[134] In order to be acceptable for FSC purposes, an exchange of information agreement must require disclosure of confidential information, since §927(e)(3)(A) specifies that the national security exception under §274(h)(6)(C)(ii) (relating to the Caribbean Basin Initiative) does not apply for purposes of the FSC provisions.[135]

Another amendment to Code §927(e) revises the statute by splitting §927(e)(3)(B) into two requirements, numbered (i) and (ii). The first requirement clarifies that an income tax treaty will allow a country to qualify as a host country for an FSC only if the Secretary of the Treasury certifies (and has not revoked such certification) that the treaty contains an exchange of information program which is satisfactory in practice for purposes of the Internal

[121] P.L. 99-514, §1881.
[122] §291(a)(4), as amended by P.L. 99-514, §1876(b)(1).
[123] *See* Senate Report at 1053.
[124] P.L. 99-514, §1876(b)(1), amending §291(a)(4) (adding flush paragraph).
[125] §245(c)(1).
[126] §245(c)(1)(B), as added by P.L. 99-514, §1876(d)(1)(A).
[127] §245(c)(4), as amended by P.L. 99-514, §1876(d)(1)(B), and as redesignated by P.L. 99-514, §1876(j).
[128] *See* Senate Report at 1055.
[129] *Id.*
[130] §904(d)(1)(H), as amended by P.L. 99-514, §1876(d)(2), and as redesignated at P.L. 99-514, §1201(a).
[131] *See* Senate Report at 1055.
[132] §927(e)(3)(A), as amended by P.L. 99-514, §1876(e)(1)(B). Specifically, the new language refers to §274(h)(6)(C), with a parenthetical reading "(determined by treating any reference to a beneficiary country as being a reference to any foreign country and by applying such section without regard to clause (ii) thereof)".
[133] Senate Report at 1056.
[134] §927(e)(3)(B)(i), as amended by P.L. 99-514, §1876(e)(1)(C).
[135] *See* Senate Report at 1056.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Revenue Code.[136] Thus, in practice, the program should provide to the United States such information as may be relevant to the determination of a United States tax liability or whether a tax-related criminal offense has been committed.[137] The second requirement clarifies that the income tax treaty must contain an exchange of information program to which that particular FSC is subject.[138] For example, a corporation incorporated in a treaty partner country, but not subject to the treaty's exchange of information program because it is not resident in the treaty partner, does not qualify for FSC status.[139]

Comment: Some countries require that, in addition to performing services, a corporation must be managed and controlled in that country in order to qualify as a resident. Thus, this provision will effectively preclude multinationals from using a "passive FSC" in a treaty country by incorporating it there because they have existing affiliates which could perform services on behalf of the FSC.

4. Maintenance of Principal Bank Accounts

Under the 1986 Act, the principal bank account of the FSC must be maintained at all times during the taxable year either in a foreign country which meets the information requirements of §927(e)(3) or in a possession of the United States.[140] This change is effective for periods after March 28, 1985.[141]

5. Taxation by United States Possessions

The two year "tax holiday" special rule under Code §927(e)(5), which precludes United States possessions from taxing FSCs on foreign trade income, is modified by the 1986 Act to permit taxation of foreign trade income generated from export sales to customers in the possessions. The moratorium on taxation, which ends on January 1, 1987, is lifted for all periods (including prior to that date) and permits the possessions to tax any income attributable to the sale of property or the performance of services for ultimate use, consumption, or disposition within the possession.[142] For example, the U. S. Virgin Islands is not prohibited from imposing a tax on the income derived from the sale of goods by a United States company (through its FSC located in the U.S.V.I.) to customers in the U.S. Virgin Islands.[143] To more clearly reflect Congressional intent in the 1984 Act, the 1986 Act clarifies that a U.S. possession may exempt from tax any foreign trade income or passive income of a FSC.[144]

Finally, the 1986 Act clarifies that no provision of law may be construed as requiring any income tax imposed by the United States on an FSC to be covered over or otherwise transferred to any United States possession.[145]

C. Changes in DISC Treatment

1. Corporate Preference Reduction

As in the case of FSCs, the corporate preference reduction in the case of certain distributions to corporate shareholders is clarified. *See* Senate Report at 1053-1054. Also, §995(b) (relating to deemed distributions from a DISC) and §996(a)(2) (relating to "qualifying" distributions) are amended to provide in effect that, in the case of a shareholder that is a C corporation, sixteen-seventeenths (16/17) of a DISC distribution to meet the qualified export receipts requirement is treated as coming out of accumulated DISC income, while one-seventeenth (1/17) is treated as coming out of previously taxed income.[146] Moreover, the amount by which the international boycott factor is multiplied is changed to sixteen-seventeenths (16/17) of the excess referred to in §995(b)(1)(F)(i).[147] These changes are intended to reflect the post-1984 Act treatment of DISC income attributable to a shareholder that is a C corporation, which deems only one-seventeenth (1/17) to be distributed and taxed currently.[148]

2. Interest Charge on Former DISC

The 1986 Act clarifies Code §995 to make it clear that an interest charge on deferred income (attributable to $10 million or less of qualified export receipts) is to be imposed on the deferred income of a former DISC in the same manner as it is imposed on a DISC.[149] Thus, taxpayers are precluded from operating an interest charge DISC for several years and then revoking the DISC election in order to avoid paying the interest charge on the accumulated DISC income of the former DISC.

3. Changes in Treatment of Old DISCs

Treatment of accumulated DISC income under the 1984 Act resulted generally in tax-exemption for such income derived before January 1, 1985, by treating actual distributions made after December 31, 1984 to be previously taxed income which was deemed distributed. The unresolved issue of how to treat distributions in liquidation is clarified in the 1986 Act, which amends §805 of the 1984 Act to include distributions in liquidation in the term "actual distribution." [150]

The other issue relating to accumulated DISC income left unresolved by the 1984 Act is the treatment of a liquidating distribution for purposes of computing the earnings and profits of any corporate shareholder of a DISC. The 1986 Act resolves this question by amending the 1984 Act to provide that the earnings and profits of a corporation receiving such a distribution must be increased by the amount of that distribution (since it is not included in income because it is treated as previously taxed income).[151]

[136] §927(e)(3)(B)(i), as amended by P.L. 99-514, §1876(e)(1)(C). *See also* Senate Report at 1057.
[137] Senate Report at 1057.
[138] §927(e)(3)(B)(ii), as amended by P.L. 99-514, §1876(e)(1)(C).
[139] Senate Report at 1057.
[140] §924(c)(2), as amended by P.L. 99-514, §1876(e)(2). *See also* Senate Report at 1057.
[141] P.L. 99-514, §1876(e)(2).
[142] §927(e)(5)(A), as amended by P.L. 99-514, §1876(f)(1). The Act divides §927(e)(5) into three subsections, (A), (B), and (C).
[143] Senate Report at 1057.
[144] §927(e)(5)(B), as amended by P.L. 99-514, §1876(f)(1). *See also* Senate Report at 1057.
[145] §927(e)(5)(C), as amended by P.L. 99-514, §1876(f)(1).
[146] §995(b)(1)(F)(i), as amended by P.L. 99-514, §1876(b)(2)(A); §996(a)(2), as amended by P.L. 99-514, §1876(k). *See* Senate Report at 1059.
[147] §995(b)(1)(F)(ii), as amended by P.L. 99-514, §1876(b)(2)(B). *See* Senate Report at 1054.
[148] *See* Senate Report at 1059.
[149] §995(f)(7), added by P.L. 99-514, §1876(g). The new subsection simply provides that the term "DISC" includes a former DISC. *See also* Senate Report at 1058.
[150] P.L. 98-369, §805(b)(2)(A), as amended by P.L. 99-514, §1876(h). *See also* Senate Report at 1058.
[151] P.L. 98-369, §805(b)(2)(A), as amended by P.L. 99-514, §1876(h). *See also* Senate Report at 1058.

4. Effective Date of Tax Year Conformity Requirement

The 1984 Tax Reform Act created a conformity rule which required that the taxable year of any DISC must be the taxable year of its owner (if there is more than one shareholder, the taxable year of the plurality of voting power controls.) The 1986 Act amends §805 to make the conformity rule apply to taxable years beginning after December 31, 1984.[152] This change is intended to apply to interest-charge DISCs, whether or not newly formed.[153]

XIV. Estimated Tax for Nonresident Aliens [Act §1841]

A. Introduction

Section 6654 of the Code imposes a penalty on individuals who do not pay their quarterly estimated income tax payments by the due dates. The penalty is basically a non-deductible interest charge based on the rate for underpayment of income tax in §6621. Prior to the enactment of the Tax Reform Act of 1984, there were four exceptions to the general underpayment penalty. Under these exceptions, no penalty was imposed on a taxpayer if total tax payments for the year (including withholding and estimated tax payments) equaled or exceeded an installment based on: (1) the preceding year's tax liability (if a return showing a liability for tax was filed for the preceding year); (2) 80% of the taxes which would be due if the income already received during the current year were placed on an annual basis; (3) 90% of the tax which would be due on the income actually received from the beginning of the year to the computation date; or (4) the tax computed by using the facts shown on the prior year's return under the current year's tax rates and exemptions.[154] While the first installment of estimated tax generally was due on April 15, certain non-resident alien individuals were not required to make their first payment until June.[155]

B. Tax Reform Act of 1984

The Tax Reform Act of 1984 consolidated a number of existing statutory provisions relating to penalties for underpayment of estimated tax as well as making certain basic changes. For example, two of the penalty exceptions noted above, those which considered 90% of the actual tax due by the date of the installment and the tax based on the prior year's income using the current year's rates and exemptions, were repealed. In addition, estimated tax payments were required for the alternative minimum tax. *See* §6654.

In making the foregoing changes, the 1984 Act inadvertently repealed the rule, contained in §6073 of the Code, which permitted non-resident alien individuals to make estimated tax payments in three rather than four installments, with the first such installment being due in June, rather than on April 15.

C. Technical Corrections

Section 1841 of the Tax Reform Act of 1986 amends §6654 of the Code by adding subsection (j) to restore the rule pursuant to which certain non-resident aliens will continue to be required to make estimated tax payments in three rather than four installments. One-half of the estimated tax required to be paid by the non-resident alien will be due on June 15, with the remaining two payments due on September 15 and January 15 of the following taxable year. This provision applies generally to taxable years beginning after 1986. *See* 1986 TRA §1881 and 1984 TRA §414(a).

---

[152] P.L. 98-369, §805(a)(4), as amended by P.L. 99-514, §1876(i).
[153] Senate Report at 1058-59.
[154] *See* §6654(d) prior to its amendment by the Tax Reform Act of 1984.
[155] *See* §6073 prior to its repeal by the Tax Reform Act of 1984.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 73

MISCELLANEOUS AMENDMENTS PERTAINING TO EXCISE TAXES

John F. Lefevere, Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction — Pre-1986 TRA Law

A. Gasoline and Gasohol Tax

1. Manufacturer's Excise Tax on Gasoline

a. Imposition of Tax

A manufacturer's excise tax on gasoline is imposed at the rate of 9 cents per gallon on the sale of gasoline sold by a producer or importer,[1] based upon the number of gallons invoiced to the purchaser. For this purpose, the term "producer" is defined to include a refiner, compounder, blender, dealer regularly selling exclusively to gasoline producers, and any person who regularly sells gasoline to aircraft owners, operators or lessees.[2] The mere use of the gasoline by the producer or importer is considered to be a sale for purposes of applying the tax.[3] Prior to incurring any liability for the excise tax, any person who will be subject to it must register with the Service.[4] The gasoline tax is scheduled to expire on and after October 1, 1988.[5]

Section 4221 of the Code provides that a manufacturer's sale on which tax would otherwise be imposed is exempted from such tax if the sale (or first retail sale) is for further manufacture, for export, for use to supply aircraft or vessels, to a state or local government (for its exclusive use), or to a nonprofit education organization (for its exclusive use).[6]

b. Exemptions

Under Code §6427(e), taxicabs which are rated at above-average fuel economy and whose drivers are not precluded from offering ride-sharing were entitled to a 4 cents per gallon exemption from the gasoline excise tax. This exemption was available through either a refund or credit. Its expiration date was extended by the Tax Reform Act of 1984 to October 1, 1985.[7]

2. Manufacturer's Excise Tax on Gasohol

"Gasohol" is any mixture of gasoline if at least 10% of the mixture is alcohol.[8] The term "alcohol" is defined to include methanol and ethanol, but to exclude alcohol produced from petroleum, natural gas, or coal.[9] A manufacturer's excise tax of 3⅓ cents per gallon is imposed on the sale of gasoline used in the production of gasohol and 3 cents per gallon on the sale of gasohol itself. This tax is effective on January 1, 1985, as a result of amendment of Code §4081 by the Tax Reform Act of 1984.[10] A gasohol producer is any person who regularly buys gasoline and alcohol in bulk quantities in the ordinary course of its trade or business for blending for resale or for use in its trade or business.[11] Any producer who has purchased gasoline for blending purposes on which the 9 cents gasoline tax (described above) has already been paid is entitled to an income tax credit of 4 5/9 cents per gallon under §6427.[12] However, if the claim for overpayment is for tax of $200 or more in any of the first three quarters of the taxpayer's taxable year (or is a claim by a governmental unit or tax-exempt organization), then a claim for refund may be made instead.[13] However, no interest is payable on the refund claim. *See* §6427(f)(1).

If the purchaser of gasohol separates the gasoline out, it is treated as a producer and taxed at 5⅔ cents per gallon on any gasoline no longer in its possession.[14]

B. Diesel Fuel Tax

1. Imposition of Tax

Under Code §4041, any liquid (other than gasoline or gasohol) which is sold for use or actually used in a diesel-powered highway vehicle is taxed at a 15 cents per gallon rate.[15] The 1984 Tax Reform Act increased the tax from 9 cents per gallon to 15 cents per gallon.[16] This retail excise tax is collected from the retailer who sold the fuel to the owner, lessee or operator of a diesel-powered highway vehicle. *See* Regs. §48.4041-1(a). However, Code §4041 does not define the term "retailer," although the Temporary Regulations do define it as "any person who sells diesel

[1] Code §4081(a).
[2] Code §4082(a) and (e). *See also* Regs. §48.4082-1(a).
[3] Code §4082(c).
[4] Code §4101. *See also* Regs. §1.4101-1(a)(1).
[5] Code §4081(b).
[6] Code §4221(a)(1)-(5).
[7] P.L. 98-369, §914.
[8] Code §4081(c)(1).
[9] Code §4081(c)(3). Moreover, the term does not include alcohol with a proof of less than 190 (determined without regard to any added denaturants). *Id.*
[10] P.L. 98-369, §912(b) and (g).
[11] *See* Regs. §48.4081-2(b).
[12] Code §6427(f)(1).
[13] Code §6427(h)(2).
[14] Code §4081(c)(2).
[15] Code §4041(a).
[16] P.L. 98-369, Act §911.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

fuel for use as a fuel in a diesel-powered highway vehicle." [17]

2. Exemption From Tax

Taxicabs meeting certain fuel economy and ride sharing requirements discussed in A, 1, b, *supra*, for purposes of receiving a partial exemption from the gasoline tax, also qualify under §6427(e)(1)(B) for a 4 cents per gallon exemption from the diesel fuel and special motor fuel [18] excise taxes. These exemptions are also available as refunds or credits and expired October 1, 1985.[19]

Intercity, local and school buses using diesel fuel also receive an exemption, in the form of a refund, pursuant to §6427(b). Although the 1984 Act increased the tax rate to 15 cents per gallon under §4041(a), the refund amount was limited to 12 cents per gallon by §6427(b), except for certain qualified subsidized intracity buses which receive the full 15 cents.[20] A qualified subsidized intracity bus is one which seats at least 20 passengers, is under contract to the state or local government (or where such government pays more than a nominal subsidy) and offers regular scheduled routes to the general public.[21] Thus, with the exception of such qualified local buses, all intercity, local and school buses began paying a 3 cent per gallon diesel fuel tax effective August 1, 1984, as a result of the 1984 Act.[22]

3. Light Weight Diesel Vehicle Credit

In order to afford some relief to purchasers of diesel-powered vehicles weighing 10,000 pounds or less who would otherwise have been subject to the full 15 cents per gallon diesel fuel tax, the drafters of the 1984 Act created a one-time income tax credit.[23] The amount of the credit depends upon the diesel fuel differential amount set forth in Code §6427 and is available to the original purchasers of such vehicles who purchased after January 1, 1985 and before January 1, 1988 (or held such a vehicle as of January 1, 1985, if purchased before that date).[24] Unless the person claiming the credit is eligible to file a claim for refund under §6427(j), the the credit must be claimed as an income tax credit.[25]

C. Retail Excise Tax On Piggyback Trailers or Semitrailers

Under Code §4051, a 12% retail excise tax is imposed on the first retail sale of certain automobile truck chassis, truck bodies, trailers and semitrailers. However, the chassis and bodies of such trailers and semitrailers are exempt from the tax if they are designed for use as both highway vehicles and railroad cars, but not if they are so-called "piggyback trailers or semitrailers." [26] The Tax Reform Act of 1984 created a special one-year reduction from 12% to 6% covering the first retail sale of a piggyback trailer or semitrailer chassis and bodies (and parts and accessories) sold between and including July 18, 1984 and July 17, 1985.[27] However, the 1984 Act also provided that if the trailer or semitrailer was actually used or resold for a non-qualified use, such use or resale is treated as an original retail sale to which an additional 6% excise tax is added. Thus, such a use or resale is effectively taxed at the full 12% rate.[28]

II. Overview of 1986 TRA Changes

The Tax Reform Act of 1986 imposes the gasoline tax at the earlier of the removal of gasoline, blend stocks or additives from the refinery or upon its first sale. A floor stocks tax is imposed on gasoline which is held by a dealer for sale on January 1, 1988 (and which has not previously been taxed by the gasoline tax). Taxes imposed on sales for certain exempt purposes are to be refunded without interest. Moreover, the partial exemption from the gasoline tax for taxicabs is extended until September 30, 1988.

The timing of the taxation of gasohol is made consistent with the taxation of gasoline by imposing the gasohol tax at the earlier of removal or sale. A special rule is created for a gasohol credit refund claim which expedites the refund process and forces the Service to pay interest if not refunded promptly.

An alternate method of collecting the diesel fuel excise tax is created by allowing a qualified retailer (with the consent of the wholesaler) to have the tax collected from the wholesaler. Qualification for the full diesel fuel credits for school buses is permitted and the one-time credit for diesel-powered highway vehicle owners and holders is clarified by adding it to the list of refundable §34 fuel credits. There is also a cut-off point established beyond which the recapture of the retail excise tax will not be imposed on the sale or resale of a piggyback trailer or semitrailer for a non-qualified use.

Miscellaneous changes include the clarification of the term "newly discovered oil" for windfall profit tax purposes, relaxed rules for the drawback of non-beverage distilled spirits imports, and the extension of the retail fuel and air transportation tax exemption for helicopters used in the development or removal of hard minerals, oil and gas.

The 1986 Act also makes technical amendments to the Tax Reform Act of 1984 with respect to the definition of "passenger automobile" in connection with both the §280F restrictions on recovery deductions and the imposition of the gas guzzler tax. The gas guzzler tax is also amended to exempt small manufacturers which lengthen existing automobiles. The provisions relating to listed property are also modified to account for the leasing of such property (including computers) and to exclude from the listed property definition any property if substantially all of its use is in the trade or business of providing for hire to unrelated persons the transportation of persons or property.

[17] Temp. Regs. §48.4041-2T, Q & A-2.

[18] Special motor fuels are defined in §4041(a)(2) as benzol, benzene, naptha, liquefied petroleum gas, casing head and natural gasoline or other liquid sold for use in a motor boat or motor vehicles.

[19] *See* footnote 7 *supra*.

[20] P.L. 98-369, §915(a).

[21] *See* Code §6427(b).

[22] P.L. 98-369, §915(b).

[23] *See* S. Rep. No. 300, 98th Cong., 1st Sess. 665 (1983).

[24] Code §6427(g)(1), (4), (5), and (6).

[25] *See* Regs. §48.6427-7(g)(1).

[26] Code §4053(7). "Piggyback trailers or semitrailers" are defined in Code §4051(d)(2).

[27] P.L. 98-369, §921, adding Code §4051(d).

[28] Code §4051(d)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

III. Detailed Analysis

A. *Gasoline Excise Tax Revised*

1. *Imposition of Tax*

The 1986 Act imposes the 9 cents per gallon gasoline tax when gasoline is removed from the refinery, manufacturing plant (or from the custody of customs), or upon its sale, if earlier.[29] This provision applies to gasoline removed after December 31, 1987.[30] The definition of "removal" added to Code §4082 states that if a refiner, importer, terminal operator, blender, or compounder uses gasoline, refined, imported, blended, or compounded by him, then such use is considered to be removal.[31] However, use in the production of gasoline or special fuels referred to in Code §4041 is not considered "removal" under the statute.[32] A statutory exception to the definition of "removal" is also made where there is a bulk transfer from the refiner or importer to the terminal operator of a registered terminal.[33] However, the terminal operator is liable for collection of the tax upon the subsequent removal of the gasoline, gasoline blend stocks, or additives from the terminal.[34]

For purposes of this rule, the term "gasoline" includes, to the extent that the Service prescribes by regulations, both gasoline blend stocks and products commonly used as additives in gasoline.[35]

The impetus for the earlier imposition of the gasoline excise tax came in part from a July 15, 1986 hearing of the Oversight Subcommittee of the House Ways and Means Committee into the scope of evasion from the tax. Deputy Assistant Treasury Secretary for Tax Policy O. Donaldson Chapoton remarked at that time that the primary problem with the gasoline excise tax system is the deferral of collection from the point of initial sale to a later date when a sale is made to the retailer or even to the ultimate consumer.[36] Although the exact magnitude of the revenue loss is unclear, it became apparent at the hearings that the tax could easily be avoided through the implementation of "daisy chain" corporations which passed title from entity to entity (often by computer) until a sale was made to a retailer. The retailer's receipt would be marked "all taxes paid," and when the government would ultimately discover that the taxes were unpaid, it would be unable to collect from the fraudulent entities.[37] Chapoton's testimony indicated that imposing the tax at the point which it is imposed by the new law would shorten the audit trail by reducing the number of audited taxpayers to 200 or 300 from 8,000.[38]

The pre-TRA requirement of Code §410 that everyone subject to the tax under §4081 register with the Service is retained,[39] and the Service is given the additional power to require the registrant to give a bond in such sum as it may require.[40] Moreover, the Service is permitted to register industrial users of gasoline blend stocks or additives as terminal operators in order to allow them to purchase such products tax-free.[41]

Code §6427 is amended to provide that if any blend stock or additive is not used by any person to produce gasoline (and such person so establishes that the ultimate use is not to produce gasoline), the Service must pay a refund, without interest, equal to the aggregate amount of tax imposed on that person with respect to the blend stock or additive.[42] It is not clear, however, in what situations blend stocks or additives would not be used to produce gasoline.

Revised §4081 also imposes a 9 cents per gallon tax on gasoline which has been removed or sold by the blender (other than registered gasohol blenders who blend at the terminal) [43] or compounder of the gasoline.[44] However, if the tax has previously been imposed, the blender or compounder is entitled to a credit in the amount of the tax paid, to the extent that the amount can be established.[45] The credit is only available to the extent that the blended gasoline (*i.e.*, gasoline, blend stocks or additives) is not used as a fuel and the refund is predicated upon the purchaser establishing that the ultimate use is not as a taxable fuel.[46]

A floor stocks tax of 9 cents per gallon is imposed on gasoline which is held by a dealer for sale on January 1, 1988 and on which no §4081 tax has previously been imposed.[47] For this purpose, the term "gasoline" has the same meaning that it does under §4082(a), so that it includes to the extent provided in regulations, blend stocks and additives.[48] The term "dealer" includes a wholesaler, jobber, distributor or retailer.[49] Moreover, gasoline is deemed to be "held by a dealer" if title has passed to him, regardless of whether it has been delivered, and if, for purposes of consumption, title has not passed on to any person other than the dealer.[50]

The floor stocks tax must be paid before February 16, 1988.[51] If there is an overpayment of the tax, the person paying the tax is entitled to a refund or credit through the application of Code §6416.[52] Finally, in determining the amount of floor stocks tax transferred to the Highway

[29] Code §§4081 and 4082, as amended by Act §1703(a). H.R. Rep. No. 841, 99th Cong., 2d Sess., II-830 (hereinafter Conference Report).
[30] Act §1703(h).
[31] Code §4081(b).
[32] *Id.*
[33] Code §4081(a)(2).
[34] *See* Conference Report at II-830.
[35] Code §4082(a)(1) and (2). *See also* Conference Report at II-830-31.
[36] *See* "Oversight Subcommittee Investigates Gasoline Excise Tax Evasion," 32 Tax Notes 201 (July 21, 1986).
[37] *Id.* at 202.
[38] *Id.*
[39] Code §4041(a), amended by Act §1703(b)(1).
[40] Code §4041(b)(2).
[41] *See* Conference Report at II-831.
[42] Code §6427(h), as added by Act §1703(e)1). Pre-TRA Code §6427(h) through (n) were redesignated as (i) through (o), respectively.
[43] *See* Conference Report at II-830.
[44] Code §4081(b)(1), added by Act §1703(a).
[45] Code §4081(b)(2).
[46] *See* Conference Report at II-830.
[47] Act §1703(f)(1).
[48] Act §1703(f)(5)(C).
[49] Act §1703(f)(5)(A).
[50] Act §1703(f)(5)(B).
[51] Act §1703(f)(3).
[52] Act §1703(f)(2).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Trust Fund for any period, such tax is treated as if it were imposed under §4081 of the Code.[53]

The 1986 Act also provides that the Treasury Department will conduct a study of the incidence of the evasion of the gasoline tax and report its findings to the House Ways and Means Committee and Senate Finance Committee not later than December 31, 1986.[54]

2. Exemption

The 1986 Act amends Code §6421, which formerly dealt only with gasoline used by local transit systems and for nonhighway purposes, to add a requirement that where gasoline has been sold to a person for certain exempt purposes under Code §4221, the Service must refund, without interest, an amount equal to the product of the number of gallons of gasoline sold multiplied by the rate at which the §4081 tax was imposed.[55] The exempt purposes are (1) for export or resale for export,[56] (2) for use by the purchaser as supplies for aircraft or vessels,[57] (3) for the exclusive use of a state or local government,[58] or (4) to a nonprofit educational organization for its exclusive use.[59]

The partial exemption from the gasoline excise tax of 4 cents per gallon for qualified taxicabs is extended for 3 years, so that it will expire on September 30, 1988.[60] Citing the energy savings achieved as a result of the partial exemption, the House Report noted that those taxpayers who will be eligible for refunds from October 1, 1985 will be able to follow the same refund procedure which was in effect prior to that date.[61] Although no effective date is supplied, the House Report indicates that the extension is effective as of October 1, 1985.[62]

B. Changes in Gasohol Tax

Revised Code §4081 retains the statutory definitions of gasohol and alcohol. However, in line with the change in taxation of gasoline, the 3 cents per gallon tax on gasohol is imposed at the time of either removal or sale of any gasoline for use in the production of gasohol.[63] Moreover, the 5⅔ cents per gallon tax imposed on a person who separates gasoline from gasohol on which the 3 cents per gallon tax has already been paid is retained, but the statute is amended to reflect the fact that the person who does the separation will be treated as the refiner of the gasoline (rather than the producer as under the old statute).[64] The conferees indicated that while registered gasohol blenders are permitted to purchase gasoline at 3 cents per gallon if blending takes place at the terminal, unregistered blenders must, like all other purchasers, purchase gasoline and gasoline blend stocks tax-paid.[65] As was the case under pre-TRA law, the tax on gasohol does not apply to removal or sale after December 31, 1992.[66]

The Act also creates a special rule for a gasohol credit refund claim. As amended, Code §6427(h) provides that a claim for refund which is for $200 or more can be filed if the period for which the refund is sought is not less than one week.[67] Moreover, if the Service has not paid the claim within 20 days of its filing, it must pay interest from that date using the rate determined under Code §6621.[68]

Note: All of the amendments discussed in this section apply to gasoline removed after December 31, 1987.[69]

C. Alternate Method of Collecting Diesel Fuel Tax Created

1. Imposition of Tax

An alternate method of imposing the diesel fuel tax is created by the 1986 Act through the addition of a subsection (n) at the end of Code §4041,[70] providing that, on the written consent of the wholesaler, the tax on the sale to a "qualified retailer" will be collected from the wholesaler instead of the retailer under regulations to be prescribed by the Service.[71] The statute defines "retailer" as any person who sells diesel fuel for use as a fuel in a diesel-powered highway vehicle, but not a person who sells diesel fuel primarily for resale.[72] For purposes of the alternate collection scheme, a "qualified retailer" is a retailer who: (1) elects, under terms and conditions prescribed by the Service, to have the alternate tax apply to all sales of diesel fuel to him by any person; and (2) agrees to notify the seller in writing that the collection of tax by the seller applies to all sales of diesel fuel by the seller to him.[73] The Service will prescribe the period or periods for which such notice and election will be effective.[74] "Diesel fuel" is defined as any liquid on which the §4041(a)(1) tax would be imposed if sold to a person who would use it in a diesel-powered vehicle,[75] unless the retailer certifies in writing to the seller that the liquid will not be sold for such use.[76]

If the retailer does not provide notice to the wholesaler that he is using the alternate collection method under Code §4041(n), the alternate method will not apply during the period in which the failure continues and any diesel fuel sold by the retailer during the period is treated as if sold by him at retail on the date he purchased it.[77] Moreover, the retailer must pay, upon notice and demand of the Service, a penalty of 5% of the diesel fuel tax imposed by §4041(a), unless the retailer can show that his failure was due to reasonable cause and not to willful neglect.[78] Finally, no

[53] Act §1703(f)(4).
[54] Act §1703(g)(1) and (2).
[55] Code §6421(c), as added by Act §1703(c)(1). Pre-TRA Code §6421(c) through (h) were redesignated as (d) through (i), respectively.
[56] Code §4221(a)(2).
[57] Code §4221(a)(3).
[58] Code §4221(a)(4).
[59] Code §4221(a)(5).
[60] Code §6427(e)(3), as amended by Act §422(b).
[61] *See* H.R. Rep. No. 426, 99th Cong., 1st Sess. 227 (1985) (hereinafter H. Rep.).
[62] *Id.*
[63] Code§4081(c)(1), as amended by Act §1703(a).
[64] Code §4081(c)(2).
[65] *See* Conference Report at II-830.
[66] Code §4081(c)(4).
[67] Code §6427(h)(3)(A), as added by Act §1703(d).
[68] Code §6427(h)(3)(B).
[69] Act §1703(h).
[70] Act §1702(a).
[71] Code §4041(n)(1).
[72] Code §4041(n)(3)(B).
[73] Code §4101(n)(3)(A)(i) and (ii).
[74] *Id.*
[75] Code §4041(n)(3)(C)(i), referring to §4041(a)(1).
[76] Code §4041(n)(3)(C)(ii).
[77] Code §4041(n)(4)(A)(i) and (ii).
[78] Code §6652(j), as added by Act §1702(b). Pre-TRA subsection (j) was redesignated as subsection (k).

exemption from the §4041(a) tax applies to a sale where the retailer elected to have the wholesaler collect the diesel fuel tax, or where the retailer elected but failed to provide notice of the election to the wholesaler.[79]

The amendments made by the 1986 Act apply to sales of diesel fuel after the first calendar quarter beginning more than 60 days after the date of enactment of the Act (*i.e.*, after the first calendar quarter of 1987).[80]

2. Changes in Exemptions

As amended by the 1986 Act, the full 15 cents per gallon refund or credit is extended to school buses, *i.e.*, buses engaged in the transportation of students and employees of schools (as defined in the last sentence of §4221(d)(7)(c)).[81] As a technical correction to the Tax Reform Act of 1984, this provision is effective as if included in that provision of the 1984 Act to which it relates.[82]

The exemption from the §4041 diesel fuel and special motor fuels tax for qualified ethanol and methanol is repealed and replaced by a "reduced" excise tax exemption, resulting in a tax of 3 cents per gallon.[83] This change takes effect on January 1, 1987.[84]

The applicability of the one-time credit available to owners (or holders) of diesel-powered highway vehicles weighing 10,000 pounds or less is clarified by adding it to the list of refundable fuel credits contained in Code §34.[85] This change takes effect as if included in the provision of the 1984 Act to which it relates.[86]

C. Change in Recapture of Piggyback Excise Tax

The Act provides a cut-off on the recapture of tax upon the nonqualified use or resale for such use. As amended, no tax will be imposed if either event occurs more than six years after the date of the first retail sale.[87] This provision is also effective as if included in the provision of the Tax Reform Act of 1984 to which it relates.[88]

D. Other Changes in Excise Taxes

1. Definition of "Newly Discovered Oil" for Windfall Profit Tax Purposes

The 1986 Act provides that a production property will not be treated as having produced oil in commercial quantities during calendar year 1978 if (1) the aggregate amount of oil produced from the property, whether or not it was sold, did not exceed 2,200 barrels in calendar year 1978, and (2) no well on the property was in production for more than 72 hours in that calendar year.[89] The change is designed to clarify the test well exception described in the legislative history to the Crude Oil Windfall Profit Tax Act of 1980.[90] The conferees indicated that no other inferences are intended in applying similar principles in areas other than §4991(e)(2).[91] For purposes of applying this rule, a dual completion will be treated as two separate wells, *i.e.*, one well for each horizon.[92] The provision is retroactively effective for oil removed after February 29, 1980.[93]

2. Non-beverage Distilled Spirits Imports

Section 7652 is amended to provide relaxed rules for "drawbacks" of medicinal alcohol, medicinal preparations, food products, flavors, or flavoring extracts containing distilled spirits which are unfit to use as beverages and are imported into the United States from Puerto Rico or the Virgin Islands. Under the revised rule, Subpart F is applied as if the use and tax determination described in §5131(a) had occurred in the United States by a United States person at the time the article was is brought into the United States and the rate were the rate applicable under §7652(f).[94] This means that, as a practical matter, the imported spirits are treated as if a United States product were involved. However, no amount is covered into the treasuries of Puerto Rico or the Virgin Islands.[95] This amendment applies to articles brought into the United States after the date of enactment of the 1986 Act (*i.e.*, after October 22, 1986).[96]

A special statutory rule is also set forth which states that §7652 (other than subsection (f)) shall not prevent the payment to Puerto Rico or the Virgin Islands of the excise taxes on the non-beverage distilled spirits noted above which were brought into the United States from either location on or before the date of enactment (*i.e.*, on or before October 22, 1986).[97] However, this rule only applies to articles brought into the United States after September 27, 1985, if the Treasury is satisfied that the amounts paid to Puerto Rico or the Virgin Islands under the rule are being repaid to the proper persons who used the distilled spirits in such articles[98] (*i.e.*, to the producers of the spirits).

3. Retail Fuel and Air Transportation Tax Exemption for Helicopters

The wording of the exemptions for helicopters from noncommercial aviation fuel excise tax and the air transportation tax is changed so that the exemption extends also to use in the development or removal of hard minerals, oil or gas.[99] This change applies as if included in the provision of the 1984 Act to which it applies.[100]

---

[79] Code §4041(n)(5).
[80] Act §1702(c).
[81] Code §6427(b)(2)(B), as amended by Act §1877(b)(1). Subparagraphs (B) and (C) were redesignated as subparagraphs (C) and (D) respectively.
[82] Act §1881.
[83] Code §4041(b)(2)(A), as amended by Act §422(a)(1)(A).
[84] Act §422(a)(3).
[85] Code §34(a)(3), as amended by Act §1877(a).
[86] Act §1881.
[87] Code §4051(d)(3), as amended by Act §1877(c).
[88] Act §1881.
[89] Code §4991(e)(2), as amended by Act §1879(h)(1).
[90] *See* S. Rept. at 1066.
[91] Conference Report at II-853.
[92] *Id.*
[93] Act §1879(h)(2).
[94] Code §7652(g)(1), as added by Act §1879(i).
[95] Code §7652(g)(2).
[96] Act §1879(i)(2).
[97] Act §1879(i)(3)(A).
[98] Act §1879(i)(3)(B).
[99] Code §4041(l)(1) and Code §4261(e)(1), as amended by Act §1878(c)(1) and (2), respectively.
[100] Act §1881. In the case of the fuel tax the effective date was April 1, 1984. P.L. 98-369, §1018(c)(1). The transportation tax was effective for transportation beginning after March 31, 1984 and paid for after that date. *Id.* §1018(c)(2).

4. Sport Fishing Tax Clarification

The sport fishing equipment excise tax provisions are corrected to indicate that they apply also to fish hook disgorgers (rather than fish "hood" disgorgers).[101] This clarification is effective on the date on which the original provision of the 1984 Act was effective.[102]

5. Alcohol, Tobacco and Firearms Return Filing

The Treasury is given regulatory authority to prescribe the place for filing of any tax return related to alcohol, tobacco, or firearms.[103] This authority is effective on the first day of the first calendar month which begins more than 90 days after the date of enactment (*i.e.*, such date falling after October 22, 1986, or February 1, 1987).[104]

6. Technical Amendments To Passenger Automobile Listed Property Rules And Gas Guzzler Tax

a. Passenger Automobile Definition

For purposes of the limitation on the investment credit and depreciation on luxury automobiles, the 1986 Act modifies the definition of "passenger automobile" in §280F so that the term refers to any four-wheeled vehicle which is manufactured primarily for use on public streets, roads and highways and is rated at 6,000 pounds *unloaded gross vehicle weight* or less.[105] The change to *unloaded* gross vehicle weight clarifies the intent of the 1984 Act that defining the term by reference to the weight of the automobile should not include the weight of the passengers or the weight of any cargo.[106] However, the pre-TRA definition ("6,000 pounds gross vehicle weight or less") is retained for trucks and vans.[107]

The same clarification of the definition of passenger automobile is made with respect to the "gas guzzler" tax (§4064).[108] A transition rule, designed by General Motors, exempts station wagons if the station wagon was a 1985 or 1986 model manufactured before November 1, 1985 and is originally equipped with more than six seat belts.[109] Moreover, an exception is made if the manufacturer under §4064 is a small manufacturer (defined generally in §4064(d)(4) as a producer who manufactured fewer then 10,000 automobiles in the latest two model years) and would be treated as a manufacturer for purposes of the gas guzzler tax solely because it lengthens an existing automobile in a model year in which it is a small manufacturer.[110] This exemption excepts the small manufacturer from the definition of "manufacturer" for purposes of imposing the gas guzzler tax.

b. Listed Property

The 1986 Act clarifies the listed property requirements in three respects. First, use in a trade or business for purposes of determining the allowable investment credit or recovery deduction for listed property is expanded to include any deduction allowable to the employee for rentals or other payments under a lease of the listed property.[111] This is in addition to the existing requirements that the use of the listed property be both for the convenience of the employer and required as a condition of employment.

The exception from the definition of the term "listed property" which is provided for any computer or peripheral equipment used exclusively at a regular business is clarified by the 1986 Act to require that the computer or equipment also be owned or leased by the person operating the business establishment.[112] This rule presumably applies also to computers and peripheral equipment used in a home office which is used as a regular business establishment.[113]

The definition of "listed property" is also clarified with respect to that portion of the definition which includes "any other property used as a means of transportation". This definition is amended to exclude property if substantially all of its use is in the business of providing services consisting of the transportation of persons or property for hire to unrelated persons.[114]

The luxury automobile, listed property and gas guzzler modifications generally take effect as if included in the provision of the Tax Reform Act of 1984 to which they relate.[115] However, the amendment for small manufacturers which lengthen existing automobiles applies as if made included in the amendments made by §201 of Public Law 95-618 (the gas guzzler provisions of the Energy Tax Act of 1978), except that in the case of qualifying station wagons, the amendment exempting manufacturers which lengthen automobiles (without regard to whether they are small manufacturers) does not apply.[116]

---

[101] Code §4162(a)(6), as amended by Act §1878(b).

[102] Act §1881. Thus it applies to sales made after September 30, 1984, unless the sales were made by related persons, in which case it applies to sales made after July 18, 1984, the effective date of the 1984 Act. *See* P.L. 98-369, §1015(e).

[103] Code §6091(b)(6), as amended by Act §1879(r)(1).

[104] Act §1879(r)(2).

[105] Code §280F(d)(5)(A), as amended by Act §1812(e)(1)(A).

[106] *See* H.R. Rep. at 943 and S. Rep. at 963 (1986).

[107] Code §280F(d)(5)(A), as amended by Act §1812(e)(1)(C).

[108] Code §4064(b)(1)(A)(ii), as amended by Act §1812(e)(1)(B).

[109] Act §1812(e)(1)(B)(iii).

[110] Code §4064(b)(5)(B)(i) and (ii).

[111] Code §280F(d)(3)(A), as amended by Act §1812(e)(2).

[112] Code §280F(d)(4)(B), as amended by Act §1812(e)(3).

[113] *See* S. Rep. at 963, citing the Conference Report to the 1984 Act, H.R. Rep. No. 861, 98th Cong., 2d Sess. 1026 (1984).

[114] Code §280F(d)(4)(C), as added by Act §1812(e)(4).

[115] Act §1881. For purposes of investment tax credit and depreciation deductions, this means property placed in service after June 18, 1984. *See* P.L. 98-369, §179(d)(1).

[116] Act §1821(e)(1)(B)(iii).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 74

CHANGES AFFECTING FINANCIAL INSTITUTIONS

Christine L. Vaughn, Esq.
Vinson & Elkins
Washington, D.C.

I. Limitations on Bad Debt Reserves

A. Commercial Banks

1. Introduction

For over 65 years, commercial banks have been permitted to establish reserves for bad debts for income tax purposes, as an alternative to a deduction for specific debts which become worthless. Under the law prior to enactment of the 1986 legislation, virtually all commercial banks computed their bad debt deductions in the form of additions to their reserves for bad debts, using methods specified in §585 of the Internal Revenue Code.

The size of a bank's bad debt reserve is determined by using either the "percentage of eligible loans" method or the "experience" method.[1] In both cases, the maximum reserve level is set by the tax code and banks have no discretion to exceed that maximum, although they can choose to set the reserve at a lower level, and can, in effect, switch between the methods from year to year.

Under a bad debt reserve approach, at the end of the year a bank computes the total amount of loans actually charged-off. That figure is deducted from the reserve account balance. Similarly, any amounts recovered on loans previously charged-off are added to the reserve account balance. After these adjustments, the bank is permitted to claim a tax deduction in an amount necessary to bring the reserve balance back to an amount no larger than the maximum permitted level.[2]

If a bank chooses to use the percentage of eligible loans method, then the maximum level of the reserve permitted in 1986 is 0.6% of "eligible loans" plus an amount determined under the experience method for loans other than eligible loans.[3] If a bank uses the experience method, the maximum reserve level is determined by analyzing the bank's actual charge-off experience over a six-year period (the current tax year, plus the preceding five taxable years).[4]

A commercial bank which does not account for bad debts through the reserve approach is allowed to deduct for tax purposes an amount equal to the actual charge-offs it incurred during the taxable year.[5]

2. Overview

Section 901(a) of the Act prohibits "large banks" from deducting any additions to a reserve for bad debts. Moreover, existing reserves must be "recaptured," either under an elective cut-off method or spread over a four-year period. A special mechanism which "suspends" recapture is provided for "financially troubled" banks.

Section 903(b) of the Act provides a special 10-year carryback for certain net operating losses (NOLs) attributable to a bank's deductions for bad debts pursuant to §166(a) of the Code.

3. Detailed Analysis

a. General Rule

Section 901(a) of the Act amends §585 to make its provisions inapplicable to "large banks." Any bank as defined in §581 of the Code will be prohibited from maintaining a reserve for bad debts if, for the taxable year or for any preceding taxable year beginning after December 31, 1986, the average adjusted bases of all its assets exceeded $500 million or it was a member of a controlled group (described in §1563(a)(1)) and the average adjusted bases of the group's assets exceeded $500 million.[6]

Bad debts of large banks subject to the new rules must be deducted when they become wholly or partially worthless within the taxable year under §166(a) of the Code.

In connection with repeal of bad debt reserves for taxpayers other than financial institutions under §805 of the Act, the Conference Report directs the Secretary of the Treasury to study "appropriate criteria" to be used to determine if a debt is worthless for federal income tax purposes. The report is supposed to "consider under what

[1] §585(b)(1). All references to the Internal Revenue Code are to the Internal Revenue Code of 1954 as it existed immediately prior to the enactment of the Tax Reform Act of 1986, P.L. No. 99-514 (1986) (hereinafter referred to as the "Act"). All references to the Internal Revenue Code, as amended, are to the Internal Revenue Code of 1986, as modified by the Act.

[2] §585(b); Regs. §1.585-2.

[3] For taxable years 1976 through 1981, the maximum reserve was 1.2% of eligible loans; for the 1982 tax year the maximum reserve was 1. 0%. Section 585(b)(2)(B) permits a bank with eligible loans at least as great as the amount of such loans outstanding at the end of a "base year" (1982 for taxable years beginning thereafter) to maintain a reserve at the level it was at the close of the base year, which for many banks will be greater than 0.6% of the taxable year's eligible loans.

[4] §585(b)(3).

[5] §166(a).

[6] §585(c)(2), as amended.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

circumstances a rule providing for a conclusive or rebuttable presumption of the worthlessness of an indebtedness is appropriate." [7] Presumably the report, which is to be completed by January 1, 1988, will include some consideration of bank bad debts.[8]

b. Recapture

The provisions of new §585(c) are treated as a change in method of accounting for the "disqualification year" that is made with the consent of the Secretary.[9] The net amount of adjustments which must be taken into account under §481(a) of the Code is to be spread over a four-year period. A bank not electing to use the cut-off method (described below) must under new §585(c)(3) include 10% of its reserve balance in income in the first taxable year for which the provision is in effect. A bank has the flexibility to designate a greater amount (up to 100% of its reserve balance) for recapture in the first year. Any balance in the reserve must then be taken into income by including 2/9 of it in income the second year, 1/3 in the third year, and 4/9 in the fourth year.[10]

A bank which desires to "run off" its existing bad debt reserve can elect the cut-off method provided in new §585(c)(4). A bank under this rule maintains its reserve as of the first day of the "disqualification year" and charges against it any losses resulting from loans held as of the same day. The disqualification year is a large bank's first taxable year beginning after December 31, 1986, if the bank maintained a bad debt reserve for the preceding taxable year.[11] The balance in a bank's reserve account under the cut-off method can be reduced only to zero. Any excess charge-offs, and any recoveries with regard to such loans, will be items of income and expense in the year of charge-off or recovery, as if the bank had always used the specific charge-off method.[12]

A "financially troubled bank" can elect to suspend the inclusion in income of its bad debt reserve for any year in which it qualifies under new §585(c)(3)(B).[13] The term financially troubled bank means any bank whose "nonperforming loan percentage" exceeds 75% for the taxable year. In the case of a parent-subsidiary controlled group (described in §1583(a)(1)), this test is applied to the group as a whole. The percentage is determined by dividing the sum of the outstanding balance of nonperforming loans for each quarter by the sum of the "amounts of equity of the bank" as of the close of each corresponding quarter.[14] Nonperforming loans are those considered to be such by the bank's "primary Federal regulatory agency," and a bank's equity is its equity "as determined for Federal regulatory purposes." [15]

c. Net Operating Losses Attributable to Bad Debts

Section 903(b) of the Act amends §172(b) of the Code to allow a 10 year net operating loss carryback and a five year carryforward for the portion of a bank's net operating loss "attributable to" its bad debt deduction under §166(a), that is, its actual charge-offs. The portion of a net operating loss attributable to a bank's deductions for losses on bad debts will be the excess of its NOL for the taxable year over the NOL computed "without regard to any deductions for losses on bad debts." [16] This special rule applies to NOLs for taxable years beginning after December 31, 1986, and before January 1, 1994.[17]

4. Effective Date

The changes made by §901 of the Act apply to taxable years beginning after December 31, 1986.[18]

B. Thrift Institutions

1. Introduction

Mutual savings banks, domestic building and loan associations and certain cooperative banks have been permitted to establish reserves for bad debts for income tax purposes since Congress subjected these institutions to the corporate income tax.[19] Under the law prior to the 1986 legislation, a thrift institution computes its reserve for losses on qualifying real property loans by using any of three methods: the experience method, the percentage of eligible loans method, or the percentage of taxable income method. The reserve for losses on nonqualifying loans is computed under the experience method.[20]

The experience and percentage of eligible loans methods apply in generally the same manner as they do in the case of commercial banks.[21]

Under the percentage of taxable income method, a thrift may deduct a percentage of its "taxable income" [22] for the year. This method is not available to a thrift whose "qualified assets" (primarily residential mortgages)[23] are less than 60% of the institution's total assets. This percentage is cut back to the extent a thrift's qualified assets are less than 82% of total assets (72% for certain mutual savings banks).[24] For taxable years beginning in 1979 or thereafter, the statutory percentage has been 40%.

The deduction for any year for an addition to a thrift's bad debt reserve cannot exceed the greater of the amount determined under the experience method or the amount by which 12% of the thrift's total year-end deposits exceed the sum of its surplus, undivided profits and reserves at the beginning of the year.[25]

---

[7] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-316 (1986) ("Committee Report").

[8] *See* Floor Colloquy between Senators Moynihan and Packwood, 132 Cong. Rec. S13956 (daily ed. Sept. 27, 1986); *but see* Response by Representative Rostenkowski in Extension of Remarks, 132 Cong. Rec. E3389, E3390 (daily ed. Oct. 2, 1986).

[9] §585(c)(3), as amended.

[10] §585(c)(3)(A)(iii), as amended.

[11] §585(c)(5)(B), as amended.

[12] H.R. Rep. No. 426, 99th Cong., 1st Sess. 578-579 (1985) ("House Report").

[13] §585(c)(3)(B)(i), as amended.

[14] §585(c)(3)(B)(iv), as amended.

[15] §585(c)(3)(B)(v), as amended.

[16] Committee Report at II-335-336.

[17] §172(b)(1)(L), as amended; Act §903(b)(1).

[18] Act §901(e).

[19] House Report at 581, fn. 7.

[20] §593.

[21] *See* §585(b).

[22] Taxable income is defined in §593(b)(2)(E).

[23] §7701(a)(19)(C).

[24] §593(b)(2)(B).

[25] §593(b)(1)(B)(ii)

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Finally, §291 has subjected any bad debt reserve deduction in excess of the amount allowable under the experience method to a 20% reduction, and an amount equal to 59-5/6% of such excess has constituted a tax preference item for purposes of the corporate minimum tax.[26]

2. Overview

Section 901(b) of the Act amends §593, retaining the experience method and a modified percentage of taxable income method for computing a thrift institution's bad debt reserve, but eliminating the percentage of eligible loans method.

3. Detailed Analysis

Section 901(b) of the Act amends §593(a) to permit any domestic building and loan association, mutual savings bank, or cooperative bank without capital stock and organized and operated for mutual purposes and without profit to deduct reasonable additions to a reserve for bad debts. Section 901(b) of the Act also modifies the percentage of taxable income method by amending §593 to reduce the applicable percentage from 40% to 8% of taxable income.

New §593(a) will only apply to a thrift which meets the 60% of total assets test set out in §7701(a)(19)(C). A thrift which *fails* the 60% asset test of §593(a)(2) will be subject to §585(a) if the thrift meets the definition of a "bank" under §581. Domestic building and loan associations are expressly considered banks for this purpose, as presumably are mutual savings banks and cooperative banks.[27] If such thrift does not qualify as a large bank, it may maintain its reserves under §585, as amended (*i.e.*, the percentage of taxable income method is unavailable).[28] A thrift with more than $500 million in assets which cannot qualify under §593 apparently will have to recapture its reserves under new §585(c)(2). The statute does not expressly deal with the situation where a thrift subject to recapture subsequently re-qualifies under §593. Presumably, a large thrift which fails the 60% asset test but intends to requalify to maintain its reserves under §593 would elect §585 recapture under the cut-off method, which retains the reserve for some period of time.

Finally, §901(b)(4) of the Act removes reserves of thrift institutions from the list of preference items subject to the 20% cutback under §291 of the Code. However, the excess of the deduction under the percentage of taxable income method over the deduction allowed on the experience method will be a preference item for corporate minimum tax purposes.[29]

4. Effective Date

The changes made by §901(b) of the Act apply to taxable years beginning after December 31, 1986.[30]

II. Interest Incurred to Carry Tax-Exempt Bonds

A. Introduction

Until 1982, commercial banks, thrifts and other financial institutions generally could hold tax-exempt obligations without losing a deduction for interest paid on their deposits.[31] With the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress imposed a 15% cutback on corporate preference items, including interest of financial institutions allocable to debt incurred or continued to purchase or carry tax-exempt obligations acquired after December 31, 1982.[32] This percentage was raised to 20% for taxable years beginning after December 31, 1984.[33]

B. Overview

Section 902 of the Act amends §265 to prohibit a deduction for any portion of a financial institution's interest expense allocable to tax-exempt interest. The Act retains the 20% reduction in a financial institution's interest deduction under §291 for certain qualifying obligations.

C. Detailed Analysis and Effective Dates

Effective for taxable years ending after December 31, 1986, §902(c) of the Act terminates the 20% reduction in a financial institution's deduction for interest allocable to tax-exempt obligations under §291 of the Code by limiting its application to tax-exempt obligations acquired after December 31, 1982 and before August 8, 1986.[34]

Interest allocable to tax-exempt obligations acquired after August 7, 1986 generally will not be deductible under new §265(b) of the Code, for taxable years ending after December 31, 1986.[35] Bonds acquired after August 7, 1986, in taxable years *ending* in 1986 are subject to the 20% disallowance rule of current law for the taxable year ending in 1986, but are subject to new §265(b) for subsequent taxable years.

The acquisition date of an obligation is the date the holding period of the acquiring financial institution begins. Thus, bonds acquired in a tax-free reorganization will not be new acquisitions for purposes of the disallowance rule.[36] Tax-exempt obligations subject to the new rules include shares of stock in a regulated investment company which distributes exempt-interest dividends during the holder's taxable year.[37]

The new rules do not apply to "qualified tax-exempt obligations" acquired after August 7, 1986, which remain subject to the 20% disallowance rule.[38] These tax-exempt obligations cannot be "private activity bonds." For purposes of this exception, qualified §501(c)(3) bonds within the meaning of §145 are not treated as private activity bonds. Qualified tax-exempt obligations must be designated as such by the issuer, which, with all its "subordinate

[26] §§291(a)(3); 291(e)(1)(A); 57(a)(7).
[27] §581; Regs. §1.581-2.
[28] §585, as amended. *See* discussion in section A, 3 of this chapter.
[29] §57(a)(4), as amended.
[30] Act §901(e).
[31] Rev. Rul. 61-22, 1961-2 C.B. 58; Rev. Proc. 70-20, 1970-2 C.B. 499; *see* House Report at 585-587.
[32] P.L. No. 97-248, 97th Cong., 2d Sess. §204(a) (1982).
[33] P.L. No. 98-369, 98th Cong., 2d Sess. §68 (1984).
[34] §291(e)(1)(B), as amended.
[35] Act §902(a).
[36] Committee Report at II-333.
[37] §265(b)(4)(B), as amended.
[38] §265(b)(3), as amended.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

entities," must reasonably anticipate that it will issue not more than $10 million of governmental and qualified §501(c) (3) bonds during the calendar year. Refundings of outstanding bonds may qualify for this exception.[39]

Section 265(b)(2) allocates a taxpayer's interest expense to tax-exempt interest in generally the same manner as had been required for purposes of §291(a)(3) of the Code. That is, interest expense will be allocated by the ratio the average adjusted bases of tax-exempt obligations acquired after August 7, 1986 bears to the average adjusted bases of all the taxpayer's assets.[40] This proportional disallowance approach, which is mandatory, overcomes the difficulty of tracing funds within a financial institution or assessing its "purpose" in accepting particular deposits.[41] "Interest expense" means the aggregate amount allowable as a deduction determined without regard to §§265 and 291, and includes amounts paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares, whether or not such amounts are actually designated as interest.[42]

Section 265(b) applies even to current interest expenses which must be capitalized. Where a portion of a financial institution's interest expense relates to preproduction expenses (such as construction period interest) which must be capitalized under §263A, the disallowance under §265(b) applies first.[43] The House Ways and Means Committee Report provides an example which shows that application of this rule results in a smaller current deduction than if the new rules applied only to deductible interest expenses.[44]

Financial institutions subject to §265(b) include those which accept deposits from the public in the ordinary course of trade or business and are subject to Federal or State supervision as a financial institution. In addition, foreign banks doing business within the United States (as defined in §585(a)(2)) also are covered.[45]

Section 902(b) of the Act also repeals the special rule of present law regarding face-amount certificate companies contained in §265(2).

Finally, a transition rule provides an exception from 100% disallowance for interest on tax-exempt obligations acquired after August 7, 1986 pursuant to a direct or indirect written commitment to purchase or repurchase such obligations.[46]

III. Special Loss Carryover Rules

A. Introduction

Financial institutions, including mutual savings banks, domestic building and loan associations, and cooperative banks, have enjoyed special rules permitting net operating losses (NOLs) to be carried back to the prior 10 taxable years and forward to the succeeding five taxable years.[47] Other corporate taxpayers may carry NOLs back three years and forward 15 years.[48]

B. Overview

Section 903 of the Act repeals the special net operating loss carryover rules for financial institutions.

Under a special rule, the carryforward period for net operating losses incurred by thrift institutions has been extended from five to eight years for taxable years beginning after December 31, 1981, and before January 1, 1986.

A special rule for net operating losses attributable to commercial bank bad debt reserves also has been provided. This is discussed above in part I, A of this chapter.

C. Detailed Analysis

1. General Rule

Section 903 of the Act limits the applicability of §172(b)(1)(F), (G), and (H) to losses for any taxable year beginning before January 1, 1987. Financial institution net operating losses for years after that date will be subject to the general rule of §172, reflecting the view expressed in the Ways and Means Committee report that net operating losses incurred by financial institutions should be treated in the same manner as NOLs incurred by other taxpayers.[49]

2. Special Thrift Carryforward

Section 903 of the Act adds a new subparagraph to §172(b)(1) to permit thrift institutions to treat net operating losses for any taxable year beginning after December 31, 1981 and before January 1, 1986 as a carryback to each of the 10 preceding taxable years and a carryover to each of the following eight taxable years. This provision applies to organizations to which §593 applies, that is, mutual savings banks, domestic building and loan associations, and cooperative banks.[50]

Congress extended the carryforward period because of the concern that net operating losses incurred by thrift institutions in the early 1980s might expire before they could be utilized, and that institutions facing this situation either might engage in "overly risky activities" in the attempt to generate sufficient taxable income to utilize the losses, or might be forced to seek tax-motivated reorganizations.[51]

It is not clear whether a thrift institution with a five-year carryforward for net operating losses generated in 1986 will be able to utilize such losses in 1990 and 1991 where income in those years is absorbed by NOLs from 1982 through 1985 being carried forward for eight years.[52]

D. Effective Dates

The termination of the special 10-year carryback rule for financial institutions applies to losses incurred in taxable years beginning after December 31, 1986.[53]

[39] Committee Report at II-334.
[40] §265(b)(2), as amended.
[41] House Report at 588-589.
[42] §265(b)(4)(A), as amended.
[43] §265(b)(6)(B), as amended.
[44] House Report at 590.
[45] §265(b)(5), as amended.
[46] Act §902(f)(3).
[47] §§172(b)(1)(F) and (G).
[48] §§172(b)(1)(A) and (B).
[49] House Report at 592.
[50] §172(b)(1)(M), as amended.
[51] S. Rep. No. 313, 99th Cong., 2d Sess. 289 (1986) ("Senate Report").
[52] See Ernst & Whinney, "Tax Reform-1986: An Analysis of Provisions Relating to the Financial Services Industry" (1986).
[53] Act §903(c)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The additional carryforward period for thrift institution losses applies to losses incurred in taxable years beginning after December 31, 1981 and before January 1, 1986.

IV. Repeal of Special Thrift Reorganization Rules

A. Introduction

The Economic Recovery Tax Act of 1981 provided special rules permitting acquisitions of certain financially troubled thrift institutions to qualify as tax-free bankruptcy reorganizations under §368(a)(1)(G).[54] These provisions were adopted to facilitate mergers of financially troubled thrifts into stronger institutions.[55]

The ERTA changes allowed tax-free reorganizations of building and loan associations, cooperative banks, and mutual savings banks undertaken in connection with a case under the jurisdiction of the Federal Home Loan Bank Board or Federal Savings and Loan Insurance Corporation (or an equivalent state authority) without regard to the "continuity of interest" requirement.[56] Application of the judicially created continuity of interest doctrine, which requires that the taxpayer's ownership interest in the prior organization continue in a meaningful fashion in the reorganized enterprise,[57] was unclear under pre-ERTA law in the case of certain reorganizations involving mutual savings and loan associations.[58]

Under §368(a)(3)(D), no stock or securities in the transferee corporation need be received or distributed in the transaction. Substantially all of the assets of the transferor must be acquired by the transferee and substantially all the liabilities of the transferor immediately before the transfer, including deposits, must become liabilities of the transferee. The provision applies only if the appropriate regulatory authority certifies that the transferor thrift is insolvent, cannot meet its obligations currently, or will be unable to meet its obligations in the immediate future, as set forth in §1464(d)(6)(A)(i), (ii), or (iii) of Title 12 of the United States Code.[59] An acquisition of a troubled thrift institution which satisfies these rules allows the acquiring corporation to succeed to the tax attributes of the troubled thrift, including its net operating losses and a carryover basis in its assets.

B. Overview

Section 904(a) of the Act repeals the special reorganization rules for troubled thrift institutions in §368(a)(3)(D), with a delayed effective date.

The treatment by the Act of net operating losses in thrift reorganizations is discussed in connection with the changes to §382 of the Code, which is found in Chapter 35.

C. Detailed Analysis

Section 904(a) of the Act amends §368(a) by deleting §368(a)(3)(D)(II) and (III).

Once these changes become effective, reorganizations involving troubled thrift institutions must satisfy the general reorganization rules in order to obtain tax-free treatment.[60] In the absence of special rules, the continuity of interest requirement presents an obstacle in the case of the merger of a stock association into a mutual association. The equity position of the stock association shareholders is exchanged for a savings account in the mutual association. Since passbook savings accounts in a mutual thrift are "cash equivalents" with an insubstantial equity interest, an interest as a depositor does not satisfy the continuity of interest requirement.[61]

With §904 of the Act, Congress determined that "financially troubled thrift institutions should no longer receive the preferential tax treatment accorded by the 1981 Act," on the grounds that the ERTA rules are inconsistent with general tax principles and unfairly benefit a selected class of taxpayers.[62]

The House bill would have repealed the special thrift reorganization rules for acquisitions after December 31, 1985.[63] However, the conference agreement provided a delayed effective date for this provision, presumably because the conferees recognized that the thrift industry may not have "fully recovered from" the economic conditions which gave rise to the ERTA provisions. In addition, as a result of §904 of the Act, the FSLIC may be forced to increase its assessments of the thrift industry for deposit insurance, and a delayed effective date provides a transition period for the FSLIC to change its deposit insurance premiums.[64]

D. Effective Date

The amendments to §368(a)(3)(D) removing the special rules applicable to thrift reorganizations apply to acquisitions after December 31 1988, in taxable years ending after that date.[65]

E. Treatment of FSLIC Payments

Since ERTA, under §597 certain payments from the Federal Savings and Loan Insurance Corporation (FSLIC) to financially troubled thrift institutions have been excluded from income and not subject to the general requirement that capital contributions received from nonshareholders reduce basis.[66] The Act repeals §597 for transfers

[54] P.L. No. 97-34, 97th Cong., 1st Sess. (1981) (hereinafter referred to as "ERTA").

[55] H.R. Rep. No. 215, 97th Cong. 1st Sess. 283-84 (1981); Jt. Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, 151-53 (1981).

[56] *Id.*

[57] *Pinellas Ice & Cold Storage Co. v. Comr.*, 287 U.S. 462, 468-470 (1933).

[58] House Report at 593-94.

[59] §368(a)(3)(D)(ii).

[60] §368(a)(1)(G).

[61] *Paulsen v. Comr.*, 469 U.S. 131 (1985); *see* The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 249 (May 1985).

[62] House Report at 595.

[63] H.R. 3838 as passed by the House of Representatives, 131 Cong. Rec. H12579-H12800, H12654 (Part III) (daily ed. Dec. 17, 1985).

[64] The President's Tax Proposals, *supra* note 61, at 251. The Administration would have delayed the effective date of this provision to January 1, 1991.

[65] Act §904(c)(1).

[66] Act §904.

after December 31, 1988 in taxable years ending after that date. The Act provides a transition rule for FSLIC payments made after 1988 pursuant to pre-1989 acquisitions.[67]

The Act also clarifies that no deduction shall be disallowed under §265(a)(1) by virtue of the fact that the deduction is allocable to FSLIC assistance payments excluded from income under §597.[68]

V. Deductibility of Losses on Deposits in Insolvent Institutions

A. Introduction

A taxpayer's ability to deduct a loss in connection with a deposit in a financial institution rests under prior law on principles applicable to bad debts generally under §166. In order to be deducted currently, a debt must become worthless within the taxable year. That is, based on all pertinent facts and circumstances, no prospect for recovery can exist.[69] Moreover, under §166(d), any debt not connected with the taxpayer's trade or business is treated as a nonbusiness debt which, to be deductible, must be totally worthless.[70] The loss on a nonbusiness bad debt is treated as a short-term capital loss which an individual can deduct only to the extent of $3, 000 plus his or her capital gains for the year (a carryforward of the excess loss is available).[71]

B. Overview

With the 1986 Act, Congress changed the treatment of certain losses on deposits by permitting a taxpayer to elect to treat such losses as casualty losses.[72] Congress chose to provide more favorable treatment to losses on deposits in insolvent financial institutions on the grounds that such losses can be distinguished from other debts, since in most cases funds are deposited with the expectation they can be withdrawn on demand, and that such losses can be better viewed as casualty losses.[73]

C. Detailed Analysis

Section 905 of the Act amends §165 of the Code to permit a taxpayer to elect casualty loss treatment for a loss incurred on a "qualified individual's deposit" on account of the bankruptcy or insolvency of a "qualified financial institution," where the amount of the loss can "reasonably be estimated." [74]

New §165(l) defines the term qualified financial institution to mean any bank, mutual savings bank, savings and loan, credit union, or any similar State or Federally chartered institution. A qualified individual is any individual other than an owner of one percent or more of the value of the stock of the qualified financial institution, an officer of such institution, or any sibling or related person of such individual (within the meaning of §267(b)). The term deposit includes deposits, withdrawable accounts or withdrawable or repurchasable shares.

An election covers all losses on deposits in the institution with respect to which the election is made.[75] The election must be made on the individual's tax return and, once made, cannot be changed without the consent of the Internal Revenue Service.[76]

Casualty losses may only be deducted to the extent they exceed $100. Moreover, §165(h) allows a casualty loss deduction only to the extent net losses exceed 10% of the individual's adjusted gross income. No carryforward is allowed. Taxpayers thus must consider whether to treat losses on deposits as short-term capital losses, thereby obtaining a $3,000 deduction with a carryforward, or to elect casualty loss treatment.

Subsequent to the adoption by the House and Senate of the conference report, the House agreed to a concurrent resolution to correct the enrollment of the bill. Among other things, the resolution contained a change affecting §905.[77] The resolution would have amended that section to provide a taxpayer with an alternate election of ordinary loss treatment where the deposit giving rise to the loss was not insured under federal law. A taxpayer's aggregate losses from each institution could not exceed $20, 000 ($10, 000 for a married individual filing separately). The resolution also made the effective date of this provision one year earlier. However, the House and Senate failed to agree to other provisions of the resolution, and it was not enacted.

D. Effective Date

The election of casualty loss treatment is available for taxable years beginning after December 31, 1982.[78]

E. Treatment of Interest on Frozen Deposits

The Act also provides a special rule covering the treatment of interest on deposits which a taxpayer cannot withdraw because of the bankruptcy or insolvency, or the threat thereof, of a qualified financial institution.[79] Section 451 has been amended to limit the inclusion in gross income of interest on frozen deposits to the net amount withdrawn by the individual during the year plus the amount "withdrawable." [80] This latter amount must be determined without regard to any penalties for premature withdrawal. Any amount not included in income is treated as credited in the next calendar year. New §451(f)(3) defers the deduction otherwise allowable to the financial institution until the interest is includible in gross income, although a special effective date provision suspends application of this rule. This provision generally applies to taxable years beginning after December 31, 1982, and before January 1, 1987, only if the taxpayer elects to have it apply for all four years.[81]

[67] Act §904(c)(2)(A).
[68] Act §904(c)(2)(B).
[69] §166; Regs. §1.166-2.
[70] §166(d); Regs. §1.166-5. *See* R.E. Keller, T.C. Memo. 1970-79, 29 T.C.M. 369 (1970).
[71] Regs. §1.166-5; §§1211, 1212.
[72] Act §905.
[73] House Report at 596-97; Senate Report at 291-92.
[74] Act §905(a).
[75] §165(1)(5). Presumably the election is intended to cover losses only for the taxable year for which it is made, but a technical correction to this effect was not adopted. H. Con. Res. 395, 99th Cong., 2d Sess. (1986), 132 Cong. Rec. H8448 (daily ed. Sept. 25, 1986).
[76] Committee Report at II-337.
[77] H. Con. Res. 395, *supra* note 75.
[78] Act §905(c)(1).
[79] Act §905(b).
[80] §451(f)(1), as amended.
[81] Act §905(c)(2)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 75

TAXATION OF INSURANCE COMPANIES AND POLICYHOLDERS

William B. Harman, Jr., Esq.
John T. Adney, Esq.
Gail B. Wilkins, Esq.
Joseph F. McKeever, III, Esq.
Davis & Harman
Washington, D.C.

I. Introduction

A. Background

The provisions of Title X of the 1986 Tax Reform Act, together with relevant portions of Title VII (relating to the alternative minimum tax) and Title XVIII (relating to technical corrections), constitute the major revisions in the tax rules governing insurance companies and their products brought about by the Act. As many and varied as these revisions are, their sweep was relatively confined in the case of life insurers — relative, that is, to the degree of change wrought by the Act upon many other classes of taxpayers. The reason, it appears, lies primarily in recent history.

The tax treatment of life insurance companies, that is, corporations taxed as life insurers under the rules of Part I of Subchapter L of Chapter 1 of the Code (Code §§801-818), was subjected to change (principally of a temporary nature) by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") [1] and then to comprehensive revision by the 1984 Tax Reform Act ("1984 TRA"),[2] essentially replacing the structure created by the Life Insurance Company Income Tax Act of 1959 (the "1959 Act"). This was equally true of the companies' products in the hands of their policyholders and beneficiaries.[3] Thus, when the President made his tax reform proposals in May, 1985,[4] their enactment with respect to life insurers would have constituted the third major alteration in the governing tax rules in as many Congresses.

The life insurance industry protested this. Indeed, the industry made efforts to "stay the course" of life insurance taxation in the face of significant proposed revisions. The tax reform plan, for example, called for the current taxation of cash value increments (the annual increase in cash value in excess of premiums paid) of life insurance and annuity contracts — the so-called "inside buildup." It also proposed greatly limiting the insurer's deduction (currently granted under Code §807) for the reserves for such contracts. Under the tax reform plan, only the insurer's reserves reflecting cash values, if any, would have been deductible. In addition, the President proposed the repeal of the 20% "special life insurance company deduction" of Code §806(a) and the "small life insurance company deduction" of Code §806(b), enacted in the 1984 TRA.

When this problem of continuing proposed change was coupled with the fact that the 1984 TRA already called for further study by the Treasury Department of the life insurance rules, with a reporting date in 1989,[5] the industry's point was viewed as well taken, especially in view of the costs and benefits to the government of making the specific proposed changes. Generally, only when buffeted by the larger issues of tax reform respecting such topics as pensions, the minimum tax, the time-value-of-money, and the overall tax rate structure did the life insurance industry tax rules undergo significant alteration.

This was not the experience of most taxpayers, of course, and the segments of the insurance industry not taxed under subchapter L, Part I, found themselves partaking of the more common experience. Insurers taxed as property and casualty (or "P/C") companies had for some time anticipated extensive tax reform proposals, although none quite so severe in effect as the President's suggestion that the tax accounting for companies' unpaid losses follow a "qualified reserve account" (sometimes shortened to "QRA") methodology. Adoption of the QRA proposal would have meant, for the first time, a mandatory reflection of the time value of money in P/C loss reserve accounting, even though such reserves generally are not "discounted" on insurers' State regulatory reports, *i.e.*, their "annual statements" filed on forms prescribed by the National Association of Insurance Commissioners (or "NAIC"). It would also have led to an effective denial of an insurer's loss deductions to the extent matched or "prorated" against tax-exempt interest or deductible dividends received.

In truth, however, adoption of the QRA proposal would have meant much more: a virtual denial of any deduction for a reserve as such, in that the QRA approach endeavored to produce a tax result equivalent to granting a deduction

[1] P.L. 97-248.
[2] P.L. 98-369.
[3] *See* TEFRA §§265-266; 1984 TRA §§221-224.
[4] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May, 1985). *See* chapters 10.06-10.13 for a description of the insurance-related proposals.
[5] *See* 1984 TRA §231.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

for losses only when and as paid. Recognition of this fact fostered the proposal's strong opposition by the property and casualty insurance industry (and by the life insurance industry, too, which also would have been affected by the QRA's adoption) and probably was significant in leading to its rejection by Congress. However, the tax changes ultimately made with respect to P/C insurers (with, again, some effect on life insurers) by the Act might well be understood as reflections of the industry and congressional reaction to the QRA proposal, for even in its rejection it helped shape the changes made just as surely as did the congressional desire for added tax revenues from P/C companies.

The P/C company taxpayers were joined in this tax overhaul experience by a number of insurers that hitherto were formally non-taxpayers, perhaps the most notable of which were the tax-exempt Blue Cross and Blue Shield ("Blue Cross" or "BCBS") organizations. That historic exemption was removed by the Act, premised on shifts in the marketing of Blue Cross insurance products that brought those products into increasing competition with the offerings of fully taxed commercial insurers. Not surprisingly, the search for added revenues also played a role in this determination.

B. Overview and Effective Dates

The following discussion will begin with a description of the relatively dramatic changes that the 1986 TRA made in the tax rules governing property and casualty insurance companies as well as certain exempt organizations providing insurance. Thus, the discussion at II, *infra*, will cover the changes made in the tax treatment of P/C companies by the following Act sections:

(A) §1021, restricting the deduction for the annual increase in unearned premiums to 80% thereof, and clarifying the rules relating to title insurance;

(B) §1022, imposing "proration" requirements by cutting back the otherwise allowable loss reserve deduction by 15% of a company's tax-exempt interest and deductible dividends received;

(C) §1023, limiting the loss reserve deduction to an amount that reflects discounting based on prescribed assumptions, a TRA-enacted rule also made applicable to the loss reserves of life insurers; and

(D) §§1024 and 1025, combining the rules for mutual and stock companies (eliminating a special deferral for mutuals and mandating a study of their taxation) and providing uniform special treatment for small companies.

The foregoing rule changes generally take effect for taxable years beginning after December 31, 1986. A similar effective date governs the 1986 TRA alternative minimum tax rules, the application of which to P/C companies is reviewed at II, *infra*. A final segment of the discussion below describes the non-Code amendment made by Act §1031, effective when the Act was signed (October 22, 1986), prescribing the tax treatment of payments made by members to an "eligible physicians' and surgeons' mutual protection and interindemnity arrangement or association."

Next, III, *infra*, reviews the rules provided in §§501(m) and 833 of the Internal Revenue Code of 1986, as added by §1012, effective for taxable years beginning after December 31, 1986. §501(m) generally denies tax exemption under Code §501(c)(3) or (4) to an organization if a substantial part of its activities consists of providing "commercial-type insurance," and also subjects to tax under the rules of Subchapter L (in lieu of Code §511) the commercial-type insurance activities of an organization that remains exempt under §501(c)(3) or (4). Post-1986 TRA Code §833 removes the tax exemption of Blue Cross organizations and taxes them as stock P/C insurance companies, albeit subject to a number of special rules designed to limit their tax burden. The effective date provision of Act §1012 contains a variety of specific exceptions to the TRA-enacted policy of denying tax exemption in the case of commercial-type insurance, and also mandates a study of one of the exceptions — certain fraternal beneficiary associations which remain tax-exempt (under Code §501(c)(8)), despite the substantial nature of their insurance activities.

The discussion in IV and V, *infra*, turns to the life insurance related provisions grouped at the outset of Title X of the Act, together with the pertinent 1986 TRA minimum tax rules of Act Title VII and the technical corrections of the 1984 TRA (and, in one case, of the insurance provisions of TEFRA) appearing in 1986 TRA §§1821-1830. Thus, IV, *infra*, will cover these changes in the corporate tax rules affecting life insurers:

(i) The repeal of the 20% special life insurance company deduction of Code §806(a) brought about by §1011 of the Act. While enactment of this aspect of the President's tax reform plan may be explained as a logical consequence of the general decrease in corporate tax rates (*i.e.*, the provision's effective reduction of the 46% rate to 36.8% was rendered "unnecessary" by the decision to cap the overall corporate rate at 34%), such an explanation fails to reckon with the fact that the timing of the repeal precedes the timing of the rate reduction, leaving life insurers with the same "blended" 40% maximum rate levied on other corporations for 1987. This repeal, however, was not accompanied, as the tax reform plan had suggested, by repeal of the Code §806(b) small life insurance company deduction.

(ii) The provision of limited transitional relief by §1011(d) of the Act, respecting the preservation of a lower tax rate on capital gains subsequently realized by certain life insurers on their investments in bonds purchased at a market discount.

(iii) The imposition of the revised alternative minimum tax on corporations, focusing on the "book income" and "current earnings" adjustments.

(iv) A variety of technical changes, including numerous alterations in the complex proration rules (made by §1821(i) and (p) of the Act), clarification of the Phase III tax rules (made by §1821(k)), refinements in the variable contract provisions (made by §1821(m) and (t)), and elaboration on the TEFRA §255 "grandfather" provision relating to certain pre-1982 modified coinsurance contracts.

Aside from the technical corrections, which generally bear effective dates as if they had been enacted as part of the

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

1984 TRA (or TEFRA), these changes are effective for life insurers' taxable years beginning after December 31, 1986

The discussion at V, *infra*, covers these changes affecting life insurance and annuity policyholders and beneficiaries:

(i) Several significant 1986 TRA rules governing life insurance policyholder treatment — nothing quite so sweeping in effect as would have resulted from enactment of the proposal to tax the inside buildup on a current basis — but including an amendment made to Code §264 (by Act §1003) limiting the deductibility of policy loan interest by business taxpayers, and a complete overhaul of the Code §7702(f)(7)(B) partial withdrawal rule (by Act §1825).

(ii) Corrections and clarifications of the 1984 TRA amendments concerning group-term life insurance under Code §79 (made by Act §1827).

(iii) Another set of major revisions in the rules respecting nonqualified annuity contracts, refining and somewhat complicating the treatment of annuitized payments, broadening the impact of the Code §72(q) penalty tax on premature withdrawals and increasing its rate from 5 to 10%, generally taxing currently the inside buildup of annuities owned by other than natural persons, and technically correcting the 1984 TRA rules relating to annuities (changes made by Act §§1122, 1123, 1135, and 1826, respectively).

(iv) Adjustments in the structured settlement rules embodied in Code §130 (made by Act §§1002 and 1826).

(v) Correction of a 1984 TRA error relating to tax-free exchanges of insurance contracts under Code §1035 (made by Act §1828).

Aside from the elements of these changes which constitute technical corrections of the 1984 TRA provisions, and which therefore take effect as if they had been enacted as part of that Act, the effective dates vary considerably. The Act §1003 amendment of Code §264, for example, is effective with respect to life insurance contracts purchased after June 20, 1986, the date that the provision was adopted on the Senate floor; the structured settlement changes made by Act §1002 apply to liability assignments entered into after December 31, 1986; and the changes respecting annuities, while frequently effective beginning in 1987, do not follow uniform effective date rules (as detailed below).

II. Property and Casualty Insurance Company Provisions

A. Unearned Premiums

Prior to the Act, Code §832(b)(4)(B) (and its predecessor provisions dating back many years) effectively allowed a property and casualty insurance company to deduct any increase in its "unearned premiums" during the taxable year in computing its taxable income. This was technically accomplished by requiring the company, in calculating its "premiums earned" (an element of "underwriting income" and hence of the company's gross income) for a given taxable year, to add unearned premiums on outstanding business at the preceding taxable year-end and deduct unearned premiums on outstanding business at the end of that taxable year. Such unearned premiums, which are shown on an insurer's NAIC annual statement and are generally described by the Income Tax Regulations as amounts reflecting the unexpired portion of insurance coverage for which premiums have been received by the annual statement reporting date, are defined by §832(b)(4) itself to include any "life insurance reserves" within the meaning of Code §816(b) that are held by the insurer.

During their consideration of the Act, both the House and the Senate weighed the propriety of continuing the historic treatment of unearned premiums against the fact that policy acquisition expenses are also fully deductible on a current basis by virtue of pre-TRA §832(b)(3) and (6). The Committee Reports underlying the Act in both houses complained that:

> "Present law permits a deferral of unearned premium income, while the expenses of earning the deferred income (*e.g.*, premium acquisition expenses) may be deducted currently. Several proposals for tax reform in the area of property and casualty insurance have suggested that permitting a deferral of an undiscounted portion of unearned premium income while allowing a current deduction for associated costs of earning the deferred income also produces a mismatching of income and expenses, and a resulting mismeasurement of income." [6]

The "several proposals for tax reform" to which the Reports referred were said by footnote to be the President's tax reform plan, a predecessor to that plan published by the Treasury Department in 1984, and a study reported by the General Accounting Office ("GAO Report") early in 1986.[7] The GAO Report turned out to be of considerable influence in this and other areas of tax reform for P/C companies.

The solution adopted by Congress with respect to unearned premiums, enacted as Act §1021, was to limit their deductibility to 80% of the annual increase. Specifically, effective for taxable years of P/C companies beginning after December 31, 1986, post-TRA §832(b)(4)(B) provides that premiums earned will be computed by adding 80% of the unearned premiums on outstanding business at the preceding taxable year-end and deducting 80% of the unearned premiums on outstanding business at the end of the taxable year. This reduction in the deductible amount, which has a parallel in the Canadian income tax provisions respecting insurers, is said by the legislative history to be done "in a manner intended to reflect costs of earning the deferred amounts." [8] The same history acknowledges that, if there is a decrease in unearned premiums in a taxable year beginning after 1986, the amended statutory provision

[6] H.R. Rep. No. 426, 99th Cong., 1st Sess. 669 (1985) (also cited as "House Report"); S. Rep. No. 313, 99th Cong., 2d Sess. 496 (1986) (also cited as "Senate Report"). One or more of these Reports (together with the Conference Report — *see* below) are referred to as the "Committee Reports" or the "legislative history."

[7] General Accounting Office, *Congress Should Consider Changing Federal Income Taxation of Property/Casualty Insurance Industry* (GAO/GGD-85-10), March 25, 1985.

[8] House Report at 669; Senate Report at 496.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

results in a reduction of the amount includible in income (*i.e.*, only 80% of it would increase gross income).

Since the amendment made by Act §1021 provided different accounting rules for unearned premiums in 1987 and thereafter than those effective through the close of 1986, it was necessary for the Act to address the treatment of the 1986 year-end balance as well. One possibility, following the lead of 1984-TRA when it altered the tax rules regarding deductible life insurance reserves, was to provide a "fresh start," that is, to disregard the difference between the closing balance of the unearned premiums under prior law and the new opening balance and forego tax on any income arising from the change in law.[9] This approach, which was utilized in the cases of the loss reserve and title insurance reserve changes (as discussed below), was rejected in this instance (largely with insurance industry support) due to revenue considerations. Instead, the excess of the 1986 year-end balance of unearned premiums over the 80% allowable under the law as amended — 20% of that balance, technically described as the "unearned premiums on outstanding business at the end of the most recent taxable year beginning before January 1, 1987" — is brought back into income ratably over a six-year period. Thus, as prescribed by post-TRA 1986 Code §832(b)(4)(C), 3⅓% of that balance is included in a P/C company's "premiums earned" in each of its taxable years beginning after December 31, 1986 and before January 1, 1993.[10]

Act §1021(b) provides a series of special rules for applying the foregoing to:

Life insurance reserves. "Life insurance reserves" as defined for purposes of Part I of Subchapter L, which are accounted for under Code §832 as an element of unearned premiums, are excluded from the 80% limitation and the 20% inclusion by virtue of post-TRA §832(b)(7)(A). The committee reports base the propriety of this on the fact that such reserves "are calculated under [Code] §807 in a manner intended to reduce the mismeasurement of income resulting from the mismatching of income and expenses."[11] This refers to §807's requirement that life insurance reserves be computed for tax purposes using a preliminary term method.

Securities insurance. A 90% limitation under post-TRA §832(b)(4)(B), and a 10% inclusion under post-TRA §832(b)(4)(C) (*i.e.*, inclusion of the closing pre-1987 balance at the rate of "1⅓" per year over six years), apply in the case of unearned premiums attributable to insurance against default in payment of principal or interest on certain debt securities. For the unearned premiums to qualify for treatment under this exception, provided by post-TRA §832(b)(7)(B), the covered securities must be described in Code §165(g)(2)(C) and have maturities of more than five years (the committee reports say that the maturities must be "five years or more").[12] Unearned premiums attributable to coverages on securities with shorter maturities are subject to the generally applicable limitation and inclusion.

Title insurance. In an effort to clarify a situation seemingly growing more confused with time,[13] post-TRA §832(b)(8) endeavors to prescribe the treatment of reserves for land title insurance. The general approach of post-TRA §832(b)(4)(B) and (C) is made inapplicable to unearned premiums in the case of title insurance, which the legislative history of the Act likens instead to loss reserves since any loss covered by a title insurance policy is "mature" at the time the coverage is issued.[14] Accordingly, the unearned premiums are subjected to discounting requirements, in a manner similar to loss reserves under Act §1023, to determine the deductible amount for purposes of post-TRA §832(b)(4)(B). These requirements are reviewed below. In addition, pursuant to Act §1021(c)(2), this change is accorded the "fresh start" and earnings-and-profits increase more generally provided in connection with the loss reserve discounting rules under Act §1023(e)(3) (also reviewed below).

A company that ceases to be taxed as a P/C company. Such a company, whether the cessation of P/C company status is due to acquiring life company status or losing tax treatment as an insurer altogether, is required by post-TRA §832(b)(7)(C) to bring into income for the last taxable year of P/C company status the entire remaining amount that it would have had to include under post-TRA §832(b)(4)(C) through taxable years beginning before 1993 had it remained taxable as a P/C company (though cessation due to corporate readjustment, under which a successor P/C is subject to Code §381(c)(22), is excused from this requirement). Thus, if a calendar year taxpaying company's closing unearned premium balance at 12/31/86 stood at $1 million, and in 1990 it ceased being taxable as a P/C company, for its taxable year ending in 1989 it would be required to include in income $133,333 (*i.e.*, the sum of 3⅓% of $1 million for each of the years 1989-1992). A question apparently left unanswered by this provision relates to the treatment of a company that did not have P/C company status in its taxable year beginning immediately before 1987 but subsequently acquired such status and then lost it again (before 1993). Is such a company required to include in income under post-TRA §832(b)(4)(C) and (7)(C) a portion of any unearned premium balance it may have had at the time the law changed, and if so, how much? As written, the post-TRA statute seems to require lump-sum inclusion of 3⅓% of that balance multiplied by the remaining number of years until 1993.

[9] *See* 1984 TRA §216.

[10] *See* H.R. Rep. No. 841, Vol. II, 99th Cong., 2d Sess. II-355 (1986) (Conference Report).

[11] Senate Report at 496.

[12] Senate Report at 497; Conference Report at p. II-355.

[13] The Conference Report, at p. II-358, rather kindly describes the tax treatment of title insurance reserves as "unclear." The Senate Report, at page 499, sets forth the series of conflicting revenue rulings showing the struggle to characterize the title insurance unearned premium reserve properly, and to avoid possible double deductions as between that reserve and certain loss reserves.

[14] Senate Report at 499.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. Proration

Unlike life insurance companies, prior to the Act, property and casualty insurance companies were permitted reserve deductions unreduced by "proration" requirements with respect to tax-exempt interest and deductible dividends received. The House Report on the Act took exception to this situation, explaining that this could be viewed as allowing a "double deduction" (or a deduction matched against excludable income):

> "No reduction in the [Code §832(b)(5)] loss reserve deduction is required, under present law, to take account of the fact that deductible additions to reserves may come out of income not subject to tax. Unlike life insurance companies, property and casualty insurance companies are not required to allocate or prorate investment income (including tax-exempt investment income) so as to take account of the possibility of a double deduction where deductible additions to reserves are funded with tax-exempt income (or with the deductible portion of dividends received).
>
> * * *
>
> "The committee believes that . . . [t]he amount of the addition to reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest or from wholly or partially deductible dividends." [15]

Accordingly, Act §1022 imposes a proration rule on P/C companies, requiring the deduction for losses incurred under post-TRA §832(b)(5) (which includes unpaid loss reserves) to be reduced by 15% of a company's tax-exempt interest and deductible dividends received. The 15% proration factor was chosen by Congress, rather than a higher percentage, out of concern that a more onerous proration requirement would effectively force P/C companies away from future purchases of instruments paying tax-favored income.

The reduction provisions, which appear as post-TRA subparagraphs (b) through (e) of Code §832(b), contain a series of special rules designed to avoid the proration of certain dividends from affiliates to the extent such dividends are not out of tax-exempt interest or non-affiliate dividends received by the affiliates. These provisions parallel rules provided for life insurance companies under Code §805(a)(4) by the 1984 TRA, as further amended by the technical corrections title of the TRA 1986 (specifically, by Act §1821(p)). Under post-TRA §832(b)(5)(B), the limitation on proration of affiliate dividends — referred to as "100% dividends," defined as any dividend 100% of which is deductible under Code §§243, 244, or 245(b), and including certain similar dividends received by foreign corporations — applies specially to two different types of dividends:

> *Dividends from non-insurance company affiliates.* Only the portion of such 100% dividends "attributable to prorated amounts," *i.e.,* attributable to tax-exempt interest and non-100% dividends received by the payor of the 100% dividends, is subject to proration under Code §832(b)(5)(B)(ii)(II). The legislative history clarifies (for these dividends as well as dividends from insurance subsidiaries, discussed next) that for this purpose, "dividends are treated as paid first out of current or accumulated earnings and profits attributable to prorated amounts; that is, it is treated as paid first out of tax-exempt income of the paying company (such as interest or the deductible portion of dividends received)." [16]
>
> *Dividends received from insurance company subsidiaries.* In addition to the foregoing, the limitation rule defined by the last sentence of post-TRA §832(b)(5)(B), together with post-TRA §832(b)(5)(E), reduces the proration (if any) of 100% dividends when those dividends are paid by an insurance company (whether the payor subsidiary is taxed as a life company or a P/C company). This reduction, which is intended to preclude proration of the same income at multiple levels within an affiliated group, is technically determined as an amount (not exceeding the payee company's share of the prorated income) equal to the payor company's share of the prorated income — whether computed under the life company or P/C company provisions — for the payee's taxable year in which the 100% dividend is received. Thus, if the payor's deductions are reduced by the applicable proration provisions by $1,000, and if the payee's deductions are so reduced (without regard to this limitation) by $400, then this anti-double proration rule relieves the payee of any reductions; but if the payee's deductions are otherwise reduced by $1,200, then this rule limits such reduction to $200.[17]

The new proration requirements are effective for P/C companies' taxable years beginning after December 31, 1986. However, by virtue of a "grandfather" exception provided in post-TRA §832(b)(5)(C), income from stock or obligations acquired before August 8, 1986, is not subjected to proration. Further, in the case of 100% dividends, any prorated portion thereof is treated as received on stock acquired on the later of (1) the date the payor of the 100% dividends acquired the instrument giving rise to its tax-favored income, or (2) the date that the payor became an affiliate of the payee. Thus, if a subsidiary is acquired after August 7, 1986, none of the prorated amounts under the dividends paid by the subsidiary is exempted from proration by the grandfather rule. Also, in the case of a subsidiary acquired on or before that date which acquires stock or obligations after that date, none of the prorated amounts attributable to such stock or obligations is exempted by the grandfather rule.[18]

[15] House Report at 670.

[16] Conference Report at II-357. In addition, the portion of 100% dividends attributable to prorated amounts is to be determined without reducing the earnings and profits for federal income taxes.

[17] House Report at 671. The similarly constructed anti-double proration rule applicable in the case of a life insurance company payee is explained in the House Report at 958 and in the Senate Report at 978. Under post-TRA §805(a)(4)(D)(v), dividends paid by a P/C company to a life company are to receive relief from double proration under "[r]ules similar to the rules of this subsection . . . .

[18] *See* House Report at 671-672; Conference Report at p. II-357. The latter also indicates that the transfer of tax-exempt bonds among affiliates after August 7, 1986, is treated as an acquisition of the bonds after that date.

C. Loss Reserve Discounting

1. *Overview; Scope of Discounting Requirement*

As noted in the introduction to this chapter, Act §1023 requires, for the first time, the discounting of loss reserves for tax purposes. Thus, as provided by Act §1023(a) and (b), the net annual increase (or decrease) in reserves for unpaid losses reflected in the post-TRA §832(b)(5) deduction for P/C companies' losses incurred, and the similar amounts reflected in life insurance companies' reserves described in post-TRA §807(c)(2) (as well as in the Code §805(a)(1) deduction), are limited to the "discounted unpaid losses" as defined in post-TRA Code §846.[19] This was done, as the Senate Report explained, to provide that the tax deductible amounts incorporate a recognition of the time value of money:

> "The loss reserves currently taken into account for tax purposes, and for State regulatory reporting on the annual statement prescribed by the National Association of Insurance Commissioners ("NAIC"), are determined for the most part as the arithmetic sum of anticipated claims payments in future years. The committee believes that present law does not accurately measure the income of property and casualty insurers. Unlike other taxpayers, property and casualty insurance companies are permitted to deduct losses prior to the time the loss is paid or accrued. The committee believes that the present-law treatment of property and casualty companies thereby permits such companies to overstate the true current cost of the insured loss; the deduction for such losses is overstated by the amount by which the nominal dollar value of a loss exceeds the present value of the insurance company's liability to pay the resulting claim." [20]

Expressly excluded from the mandated discounting are "losses on life insurance contracts," [21] and implicitly excluded by the statutory structure (as expressly confirmed by the legislative history) are those amounts which meet the requirements for "life insurance reserve" treatment under Part I of Subchapter L. In these cases, it was not deemed necessary to apply a new set of discounting rules. Life insurance reserves in particular, which include certain reserves for noncancellable accident and health ("A&H") insurance, were acknowledged by the legislative history to be subject to their own, fully implemented discounting rules.[22]

Also made subject to the discounting requirements, however, were the unpaid loss adjustment expenses ("LAEs") of P/C companies. This was accomplished by redefining unpaid losses to include LAEs, simultaneously excluding them from their historic place in Code §832(b)(6). On the other hand, according to the legislative history, life insurance companies (unlike P/C companies) may not deduct even the discounted amounts of LAEs unless the latter qualify for deduction under the normal tax accrual standards.[23]

The TRA-enacted definition of "discounted unpaid losses" in post-TRA §846, setting forth the fairly complex methodology by which the discounted amounts are to be computed, concludes with a grant of authority to the Treasury to write "necessary or appropriate" regulations implementing the new provision. Included within this grant is a specific direction to deal with the "proper treatment" of salvage and reinsurance recoverable with respect to unpaid losses, a subject which, though relevant to the computation of unpaid losses generally, is extraneous to discounting.[24]

2. *Discounting Methodology*

Under post-TRA §846, the discounting is generally to be accomplished by applying discount factors to a company's loss reserves as shown on its annual statement for the taxable year — referred to as the "undiscounted unpaid losses" — using a separately computed factor for each "accident year" for each "line of business." The computation of the factor for each of these, which is described in §846 as if it were to be made by the taxpayer even though Congress said it expects the Treasury to promulgate the newly applicable set of factors each year,[25] is to provide an approximation of the present value of the reserve amount at the taxable year-end employing (1) a statutorily prescribed interest rate and (2) a loss payment pattern based on certain annual statement data. To understand what is meant by this, certain definitions are necessary:

> *Undiscounted unpaid losses.* While the amount of unpaid losses (together with LAEs) shown on a company's annual statement ultimately limits the amount of the discounted unpaid losses for a given line of business and accident year; [26] in undertaking the computation of the discounted amount the company is permitted to "back out" any discounting already performed in arriving at the annual statement figure. Thus, in making the post-TRA §846 computation, a discounted annual statement reserve (such as one for workers' compensation) may be "grossed up" before applying the tax discount factor to it, provided that the

[19] This is technically accomplished, in the case of P/C companies, by changing the deduction of post-TRA §832(b)(5)(A)(ii) (as already amended by §1022 of the Act) from "unpaid losses" to "discounted unpaid losses (as defined in §846." In the case of life insurance companies, the change was made by adding a new sentence at the end of post-TRA §807(c) specifying that the amounts of the unpaid losses under paragraph (2) thereof, together with any such amounts deductible under §805(a)(1), are to be the "discounted unpaid losses as defined in section 846."

[20] Senate Report at 499-500.

[21] The unpaid losses on life insurance contracts are excluded by means of a parenthetical phrase appearing in the new final sentence of post-TRA §807(c) added by Act §1023(b).

[22] Referring, of course, to the requirements of post-TRA §807(d). *See* Senate Report at 501; Conference Report at II-361. As previously noted, such life insurance reserves held by a P/C company are accounted for as part of unearned premiums under Code §832(b)(4). For a life company, they are described in §§807(c)(1) and 816(b).

[23] *Compare* Act §1023(a)(2) (changing the definition of unpaid losses "[f]or purposes of this subchapter") *with* Conference Report at p. II-361.

[24] *See* post-TRA §846(g); Senate Report at 501.

[25] Senate Report at 504. Adoption of this approach may constitute one of the few true simplifications achieved by the 1986 Act. As discussed below, however, a taxpayer may elect to make the computations (based on its own loss payment experience).

[26] Technically, under post-TRA §846(a)(3), the limit is the aggregate amount thereof included on the company's annual statement filed for the year ending "with or within" the taxable year. The imposition of this limit is explained as a measure to curb possible "abuse" of the general approach of beginning the discounting computation with "undiscounted" reserves (even though these may exceed the annual statement reserves). *See* Senate Report at 503.

amount and rate of the annual statement discount are ascertainable from information filed on or with the statement itself.[27]

Accident year. Following industry usage, post-TRA §846(f)(1) defines an accident year as the calendar year in which an incident occurs that gives rise to the related unpaid loss. Schedules O and P of the fire and casualty annual statement (on which the design of post-TRA §846 was based) segment the reserves by accident year, with the number of years shown in a loss development being dependent on whether a particular line of business (*see* below) is considered to have a "short tail" (with virtually all claims arising in a given year being paid out in a few years) or a "long tail" (with claims payments being made many years into the future).

Line of business. Also adhering to industry usage, post-TRA §846(f)(4) defines a line of business to mean a loss category reported on the fire and casualty annual statement. Thus, the legislative history refers specifically to the lines reported on Schedule O, which principally involve short tail business such as fire and auto collision but which include certain longer tail disability income coverages, and to the Schedule P lines, which are comprised of long tail business. On a given annual statement, the Schedule O lines show a three-year development of reserves, dividing into the reserves for the accident year concurrent with the statement (the "AY"), those for the immediately preceding accident year ("AY+1"), and those for all prior years ("AY+2"). The Schedule P lines — which the legislative history identifies as consisting of five categories (one of which, "multiple peril," is treated as a single line) — show the reserve development over 11 years, or from AY through AY+10 (the last of which represents "all prior" accident year reserves).[28]

Thus, for each new accident year as it emerges, there will be (since the interest rate potentially changes each year) 11 new discount factors for each Schedule P line of business and three new discount factors for each Schedule O line of business.[29] As the accident year for the particular line of business ages from one taxable year to the next, the "discounted unpaid losses" relating thereto will be computed by multiplying the relevant "undiscounted unpaid losses" by the next succeeding factor in the series determined at the outset of that accident year. In other words, once the factors are computed, their recomputation with reference to subsequent experience is neither required nor permitted.[30] Under Act §1023(e)(2), the factors determined for the 1987 accident year are also to be applied in discounting the reserves for all prior accident years.

3. Interest Rate

Under post-TRA §846(c), the interest rate used in computing the discount factors for a given new accident year is an average of "applicable Federal mid-term rates" effective as of the beginning of each of the calendar months in a "test period." For this purpose, the rates in question are those defined in post-TRA §1274(d), converted to a rate based on annual compounding, and the test period refers to the most recent 60 calendar months ending before the beginning of the new accident year. However, to avoid the retroactive effect of employing interest rates that predated the congressional judgment to impose discounting requirements, the test period is deemed not to include any month before August, 1986.

By virtue of the foregoing definition, the interest rate to be used in discounting the reserves for an accident year (in their first year and as they age) will be known by the beginning of that accident year. As a transitional matter (as already indicated), the interest date applicable to the 1987 accident year, based on the last five months of 1986, will apply as well to pre-1987 accident years.[31] That rate is expected to be approximately 7.2%.

4. Loss Payment Pattern

While the Secretary of the Treasury is expected to announce the discount factors, it is really the loss payment patterns that post-TRA §846(d) requires the Secretary to announce. Under §846(d), these patterns are to be determined for each line of business once every five years, beginning in 1987 (with 1987 and each fifth year thereafter being referred to as a "determination year"), based on the most recently published aggregate annual statement data available at the beginning of each determination year. Given the typical lags in filing and compilation of annual statement data, this means that 1985 data will be used for the 1987 determination, 1990 data will be used for the 1992 determination, and so forth. Again, once a pattern (through the series of discount factors) attaches to an accident year, it continues to govern the discounting of the reserve for that year as it ages.[32]

The Secretary is specifically required to announce, for each line, the "historical" loss payment pattern. The statute does not expressly define this term, but its meaning is relatively clear from the Committee Reports as well as from the model on which this aspect of the methodology was based, *i.e.,* the discounting discussion in the GAO Report.[33] The intention here is to have the Secretary (or an electing taxpayer under post-TRA §846(e), as discussed below) determine a loss payment pattern from the reserve development appearing in the applicable annual statement data (under Schedule O or Schedule P, as the case may be), and then to apply this pattern prospectively to the reserve development for the five accident years beginning with the determination year. The implicit assumption is that a recent loss pattern (showing payments made in 1985 for accident years 1985, 1984, 1983, etc.) would be a sufficiently appropriate indicator of how the loss reserves

[27] Post-TRA §846(b); Senate Report at 503.

[28] Senate Report at 501-502.

[29] At this writing (mid-December, 1986), it is unclear whether the Schedule P lines will have 11 factors or, in certain cases due to special "long tail" rules discussed below, more than 11 factors. *See* Conference Report at II-363. Since there are 11 amounts reported on the annual statement for each line of business, it would appear sensible to terminate the computation at the 11th factor.

[30] *See* Senate Report at 504.

[31] Conference Report at p. II-360 (modifying Senate Report at 504).

[32] Senate Report at 504-505.

[33] Senate Report at 505, 508; Conference Report at II-361-366.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

held in a later (*e.g.*, 1988) would subsequently be paid out for accident years of then comparable age (*e.g.*, accident years 1988, 1987, 1986, etc.). To translate this into symbols, a payment pattern would permit discount factors to be developed for a Schedule P line for AY, AY+1, AY+2 ... AY+10, viewed from the standpoint of the applicable statement data available at the outset of a determination year, and those factors would then apply to determine the discounted reserves for AY, AY+1, AY+2 ... AY+10, viewed from the standpoint of the annual statement for the taxable year. Of course, as discussed above, the factors for each succeeding accident year would also reflect the applicable interest rate for that year.

The data that the Secretary is to use in promulgating loss payment patterns (and discount factors) is aggregate, insurance industry-wide data. The legislative history identifies the sources of this data as: (1) for most cases, the "Aggregates and Averages" compendium published by A. M. Best & Company, summarizing industry payout patterns by line of business and accident year as reported on Schedules O and P of the annual statement; and (2) for title insurance, comparable information published by the American Land Title Association (which the Senate Report says it expects to show payment patterns at least as long as the Schedule P patterns).[34] Under post-TRA §846(d)(3)(F), if longer payout patterns than those presently reported in such data ultimately become available — *e.g.*, if Schedule P's reporting is extended such that AY+10 becomes a free-standing accident year and a new AY+11 becomes the "all prior" category — the Secretary is directed to take the additional data into account in performing the discounting computations.

After specifying the basic external data to be employed in determining its loss payment patterns, post-TRA §846 goes on to provide certain "computational rules" (sometimes arbitrary ones) to be followed in constructing the final, official patterns. These include:

- An assumption that claims are paid in the middle of the year.
- For Schedule O lines, an assumption that losses paid after the first year following the accident year are paid equally in the two following years.
- For Schedule P lines, in certain circumstances a division of the the "all prior" category (AY+10) into discrete accident years, according to a statutory formula is permissible. Under the formula, if the losses which would otherwise be treated as paid in the 10th year following the accident year (the "normal" rule) exceed those treated as paid in the ninth year, the payment pattern is extended as if the losses continued to be paid at the ninth year rate. In any event, this extension of the pattern beyond the period of the normal rule is capped at five years. Still other refining rules specify how the deemed extension is to function if the ninth year payment rate is zero or negative.[35]

[34] Senate Report at 505.

[35] The extension rule is discussed at some length on pages 506-507 of the Senate Report and is illustrated on pages II-362-366 of the Conference Report.

5. Special Rules

Not surprisingly, exceptions are provided to one or more aspects of all of the foregoing rules of post-TRA §846. The general loss payment pattern determination under §846(d) is overriden in three specific cases: (1) if the company so elects, choosing in a determination year to follow its own annual statement experience for the five accident years beginning with that determination year (§846(e)); (2) in the case of the "international" and "reinsurance" lines of business appearing on Schedule O (§846(d)(3)(E)); and (3) in the case of title insurance (§832(b)(8), as added by Act §1021(b)). Some comment on each of these is appropriate.

The §846(e) election is permitted out of a recognition that the use of industry-wide data to determine the discount factors may not always be appropriate in the case of a particular company's loss reserves. To avoid requiring any company to reduce its loss reserve deduction by an amount greater than necessary to reflect the time value of money, §846(e) allows a company to make a periodic election (irrevocable absent the Secretary's consent) to use its own loss reserve payment data in computing the discount factors for *all* of its lines of business. The loss payment data to be used by an electing company in computing the factors for any accident year (which, once computed, may not be redetermined by the company) is that drawn from its then most recently filed annual statement, although the methodology employed in making the computations is generally the same as that used by the Secretary (as modeled on the illustration in the GAO Report). Regulations are authorized to prevent abuse of the provision if a company does not possess sufficient historical loss payment data or if multiple corporations are used (to avoid the "all-or-nothing" nature of the election), and in no event may the election apply to the international and reinsurance lines or to A&H business.[36]

A special rule was provided in the case of the international and reinsurance lines of business to prevent possible abuse. The loss reserves reported on these lines in Schedule O optionally may be reported in other Schedule O or P lines to which the reserves relate; as a result, some of the coverages involved have longer payment tails than Schedule O lines generally. Accordingly, the discounting provisions are required to be implemented, for reserves reported for these lines, on the basis of (presumably three) composite discount factors derived by combining the payment patterns for all Schedule P lines. In addition, the Secretary is authorized by post-TRA §846(g)(1) to issue regulations addressing "the proper treatment of allocated reinsurance," thereby providing a means of precluding distortions in the loss payment patterns due to individual companies' decisions to allocate reinsurance to specific lines or to report it, unallocated, on the Schedule O reinsurance line.[37]

The title insurance discounting rules, while formally representing more than a mere exception to the general loss payment patterns rules, in practicality amount to such. The title insurance unearned premiums under post-TRA

[36] Senate Report at 508-509; Conference Report at II-361.

[37] Senate Report at 502, 507; Conference Report at II-360-361.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

§832(b)(8)(B), like the loss reserves under Code §846(a)(2), are converted to a discounted figure by computing the present value of the undiscounted amounts (in the title insurance case, drawn from the annual statement without exception) for each new calendar year's worth of premiums using the §846(c) interest rate determined for that year and "applicable statutory premium recognition pattern." Thus, basically, only with respect to the statutory premium recognition pattern does the scheme for discounting unearned premiums on title insurance diverge from the general §846 rules, and the legislative history makes it clear that other title insurance reserves, namely, the known claim or "case" reserves, are to be discounted applying the general rules.[38] The same history specifies that the reference to "statutory" in connection with the premium recognition pattern means State statutes: the rate and amount of inclusion of the unearned premiums in a company's income for State statutory accounting purposes determine the timing and amount of releases from the unearned premium reserve which are included in income for tax purposes. (The subjection of title insurance unearned premiums to discounting also carries with it the benefit of a "fresh start," as explained below.)

A final exception, even more sweeping in nature, is provided with respect to certain A&H loss reserves under post-TRA §846(f)(6). Some A&H reserves are life insurance reserves within the requirements of Part I of Subchapter L, and of course, these are not touched by the §846 rules. The remaining A&H reserves are described in the legislative history as relating primarily to cancellable disability insurance and medical reimbursement coverage, and of these, only the reserves for credit disability insurance are left subject to the general discounting rules.[39]

The rest of the disability reserves are to be discounted, according to post-TRA §846(f)(6)(A), following a methodology similar to that prescribed in §807(d) for noncancellable disability insurance reserves.[40] In specific terms, the discounted amounts of these reserves are to be computed using the general rules of §807(d) applicable to noncancellable A&H contracts, including the §807(d)(4) "prevailing State assumed interest rate" relevant to such contracts. Nonetheless, three differences are provided:

- The prevailing interest rate is determined in this context on an accident year basis, rather than with reference to the year of contract issuance.
- The limitation of the tax deductible amount of the reserve to no more than the amount showing on the annual statement (whether or not discounted) is based on the §846(a)(3) aggregate approach rather than on a contract by contract approach (as under §807(d)(1)).
- Recognizing that, at this time, there does not appear to be any generally used mortality or morbidity table applicable to cancellable A&H coverages, the mortality or morbidity experience to be employed in the discounting is the company's own experience.

Apart from the loss reserves for disability coverages, the remaining A&H loss reserves, mainly involving medical reimbursement claims, are required by post-TRA §846(f)(6)(B) to be discounted using the general §846 rules with the exception that, in lieu of a loss payment pattern, the discounting is to be done assuming that all claims for which the reserves are held at any year-end will be paid one-half year later.

6. Effective Date; Fresh Start

The 1986 TRA discounting requirements are effective for taxable years beginning after December 31, 1986. As a transitional matter, Act §1023(e)(2) specifies that the unpaid losses and LAEs at the end of the year preceding the first year under the new requirements are to be redetermined as if they had already been discounted in accordance with §846. Act §1021(c)(2) makes similar provision with respect to title insurance unearned premiums.

Act §1023(e)(3) (together with Act §1021(c)(2)) then grants the affected taxpayers a "fresh start," that is, no income is allowed to arise from the change in the tax reserve figure due to the transition. That provision further specifies that a company's earnings and profits are increased by the amount of such change. However, to combat possible abuse of the fresh start (by a taxpayer's arbitrary increase in the reserves prior to the change for the sole purpose of expanding the fresh start benefit), the forgiveness of income is denied to the extent of any "reserve strengthening in a taxable year beginning in 1986." The legislative history endeavors to shed some light on the meaning and effect of the foregoing phrase, though with limited success.[41] It seems fairly certain that this forbidden reserve strengthening includes "additions" to reserves for accident years prior to 1986, along with any other unallocated or unspecified additions. It is less than clear, however, exactly what differences from historic assumptions that a company might use in determining unpaid losses for the 1986 accident year that would cause a portion of the new reserve to fall on the unfavorable side of the line. As to the effect of this rule, it appears (albeit with room for debate) that the decline in a reserve at the point of the new statute's transition would, to the extent of the strengthening, count as part of the reserve after the statute takes effect so as to lessen the overall reserve deduction (*i.e.*, producing income) at that time.

D. Other Significant Changes and Studies

Through enactment of Act §§1024 and 1025, Congress sought to achieve, with respect to P/C companies, some streamlining of the tax rules for now (especially with regard to mutual companies) and the commencement of studies to facilitate further changes in the future. Act

[38] Conference Report at p. II-366-367.

[39] Senate Report at 508. Credit disability insurance was carved out of the A&H exception because Congress considered it to be "more in the nature of a property and casualty" coverage. *Id.* The major difference that this means for credit disability reserves, as compared with their non-credit counterparts, is that they will be discounted using a typically higher interest rate (the "new money" type of rate prescribed under §846(c)).

[40] This exception was made largely out of deference to the fact that a great portion of the affected reserves are those held by life companies, rather than P/C companies. Life companies are already familiar with the §807(d) rules, and the manner in which life companies compute their loss reserves for cancellable disability coverages frequently is not dissimilar to that used in computing the reserves for noncancellable business.

[41] *See* Senate Report at 510; Conference Report at p. II-367.

§1024, in particular, is a lengthy, hyper-technical provision which does not require detailed review here. However, these highlights of Act §§1024 and 1025 are worth noting:

Repeal of "PAL" account. Act §1024 repeals Code §824, which essentially provided a rolling five-year deferral of certain amounts by mutual P/C companies under the rubric of the Protection Against Loss, or "PAL," Account. Congress reasoned that this deferral was no longer appropriate, particularly since the provision did not condition the availability of its benefit on a company's setting aside of the tax deferred amounts as a "cushion" in its surplus. The repeal is effective for taxable years beginning after December 31, 1986, except that amounts in PAL accounts at the point of the repeal are required to be recovered and included in income in accordance with the Code §824 rules.[42]

Adoption of uniform small company relief provisions. In lieu of the complicated series of exemptions, special rates, and special deductions for small mutual companies, an exemption is provided under post-TRA §501(c)(15) for stock and mutual P/C companies if a given company's net or direct written premiums (whichever is greater) does not exceed $350,000 — taking account of all such premiums received by affiliates within the company's "controlled group" as defined in post-TRA §831(b)(2)(B)(ii). In addition, for a stock or mutual P/C company with greater premium income that still does not total beyond $1.2 million (again taking into account affiliates' premiums), post-TRA §831 permits the company to elect to be taxed only on its investment income. The effective date, again, is for taxable years beginning after December 31, 1986.

Restructuring of Parts II and III of Subchapter L. Parts II and III of Subchapter L under prior law are consolidated into Part II, relating to *all* P/C companies, and Code §§822 and 826 are redesignated as Code §§834 and 835, respectively. *See* Act §1024. Thus, Part II now consists of §§831 (tax imposed), 832 (determination of taxable income), 833 (Blue Cross organizations, discussed below), 834 (determination of taxable investment income), and 835 (election by reciprocal). Post-TRA §846, along with §§841-846, make up redesignated Part III of Subchapter L.

Multiple studies. Act §1025 is designed to keep the Treasury Department fully employed over the next few years with consideration of, and report-writing on, P/C companies' taxation. Specifically, the Secretary is required to report to the tax-writing committees of both houses of Congress, and to the Joint Committee on Taxation, the results of studies and recommendations pertaining to (1) the treatment of policyholder dividends by mutual P/C companies (*i.e.*, addressing whether an "ownership differential" provision similar to Code §809, applying to mutual life insurers, should be imposed on mutual P/C companies), (2) the treatment of P/C companies under the new alternative minimum tax rules (discussed next), and (3) the operation and effect, and revenue raising record, of the P/C amendments made by the Act. These reports are due January 1, 1989.

E. Alternative Minimum Tax

The revised corporate alternative minimum tax imposed by Title VII of the Act is reviewed in detail in Chapter 33 of this portfolio and, as it applies to life insurance companies, later in this chapter. This totally restructured and far stronger "income tax inside of an income tax" applies to P/C companies, and, in so applying, makes use of the same "net book income" and "adjusted current earnings" rules as govern the treatment of life companies. With regard to the latter, however, the legislative history records two rules specific to P/C companies: (1) the post-TRA §831(b) election allowing a small company to be taxed on its investment income does not apply, and (2) the capitalization and amortization of policy acquisition expenses beginning in 1990 is not required of P/C companies because of the unearned premium deduction limitation imposed by Act §1021.[43]

F. Certain Physicians' and Surgeons' Associations

In a lengthy non-Code amendment, Act §1031 prescribes the treatment (under the general rules of the Code) of an "eligible physicians' and surgeons' mutual protection and interindemnity arrangement or association," defined to be an arrangement or association operating under state law (other than state insurance law) prior to 1984, effective after the date of enactment of the Act (October 22, 1986). The main thrust of this otherwise curious provision — which may have some interest for those concerned with the tax treatment of capital paid into mutual insurers and of the returns on that capital paid out by such insurers — is the clarification of the treatment of amounts that might be considered "founders' capital." Under the provision, contributions to such an eligible pooled medical malpractice association are currently deductible by the member-insureds under Code §162 to the extent that they do not exceed the cost of a commercial insurance premium for comparable annual coverage (as determined by the Secretary). Also, such contributions, to the extent deductible, are included in the income of the association. On the other hand, the non-deductible portion of an "initial payment" (applying the foregoing rules) is not income to the association, nor is its return (as measured by specified ordering rules) deductible by the association. Refunds of deductible payments are, of course, included in a recipient member's gross income.

III. Exempt Organizations Providing Insurance

A. Organizations Providing Commercial-Type Insurance

Section 501(c) of the pre-1986 Code provides various standards that an organization must meet to qualify for

[42] House Report at 676-677; Senate Report at 510-511; Conference Report at p. II-369-370.

[43] Conference Report at p. II-277. As an interesting historical point, it should be noted that the net book income element of the new minimum tax rules was foreshadowed by a P/C company provision in the House version of the Act. That provision was deleted in favor of the new loss reserve discounting rules and in recognition of the broad application of the post-TRA tax rules.

exemption from federal income tax. Such an organization, however, generally is taxed on any income from a trade or business that is unrelated to the organization's exempt purposes. In recent years, a number of 501(c) organizations began to engage in insurance activities to such a degree that their commercial activities were competing directly with taxable insurance companies. Although the Service had examined the activities of some of these organizations, their tax-exempt status had not been revoked and, by and large, the insurance activities of such organizations were not subjected to the unrelated trade or business tax.

In the 1986 TRA, Congress examined the conduct of insurance activities by such organizations and concluded that certain exempt charitable and social welfare organizations were engaged in insurance activities to such a degree that their commercial activities should preclude tax-exempt status.

Act §1012 amends Code §501 to provide that a Code §501(c)(3) organization [44] (*i.e.*, a "charitable" organization) or a Code §501(c)(4) organization [45] (*i.e.*, a social welfare organization) will be exempt from federal income tax only if no substantial part of such organization's activities consists of providing commercial-type insurance. Post-TRA Code §501(m)(2) provides that, in the case of charitable or social welfare 501(c)(3) or (4) organizations, the activity of providing commercial-type insurance will be treated as an unrelated trade or business under Code §513. Such insurance trade or business will, however, be taxed under the rules relating to insurance companies under Subchapter L, not under the unrelated trade or business rules of Code §513.

For these purposes, commercial-type insurance is generally any insurance of a type (including the issuance of annuity contracts) provided by commercial insurance companies. Post-TRA Code §501(m)(3) specifically provides that commercial-type insurance does not include (1) insurance provided at substantially below cost to a class of charitable recipients and (2) health insurance provided by health maintenance organizations (HMOs) that is customarily provided by such organization and that is incidental to the HMO's principal activity of providing health care. In addition, the term does not include property and casualty insurance or retirement and welfare benefits provided directly or through a wholly owned corporation by a church or an organization of churches for the church or organization or, in the case of retirement and welfare benefits, for the employees of the church or organization and the beneficiaries of such employees.

B. Blue Cross and Blue Shield Organizations Similar Organizations

Act §1012(b) amends the Code to make Blue Cross and Blue Shield organizations existing on August 16, 1986, and new Blue Cross and Blue Shield organizations that meet certain requirements discussed below, subject to tax generally as stock property and casualty insurance companies under Part II of Subchapter L of the Code (as amended by the Act). Such organizations, however, will be entitled to special treatment not otherwise accorded taxable property and casualty companies. First, 1986 Code §833 provides a special deduction for such organizations equal to 25% of the year's annual claims and administrative expenses attributable to health insurance business, less the adjusted surplus at the beginning of the year. The expenses attributable to health business are those incurred during the taxable year in connection with the administration, adjustment, or settlement of claims under health business.[46] The 25% special deduction, however, may not reduce taxable income attributable to health business for the year (without regard to the special deduction) below zero.[47]

For organizations eligible for this deduction, the amount of the adjusted surplus for the first year of the deduction is the surplus reported on the annual statement at the close of the preceding year.[48] In the case of organizations eligible for the deduction in the first taxable year beginning after December 31, 1986, Act §1012(c)(3)(B) requires that surplus be adjusted by not taking into account distributions (such as distributions to shareholders, or contributions or loans to affiliates that reduce surplus, but not including ordinary and necessary expenses or deductible policyholder dividends) after August 16, 1986, and before January 1, 1987.

Code §833(b)(3) requires that the initial surplus amount be adjusted for all eligible organizations at the close of each taxable year by adding the taxable income or loss of the organization for the year (determined without regard to net operating loss carryovers and without regard to this special deduction) plus net exempt income for the year. Code §833(b)(3)(E) defines net exempt income to mean dividends for which the dividends received deduction was allowed, and interest that is tax-exempt, less the expenses of earning the tax-exempt interest that were disallowed under Code §265, and less the adjustment that was made for proration of tax-exempt income under Code §805(a) or Code §832(b)(5). If an organization eligible for the special deduction does not take the deduction in any year, adjusted surplus must be calculated for the intervening years between the last year the organization took the deduction and the next year in which it takes the deduction, so as to take account properly of the calculation of the deduction in the later year.

The 25% special deduction applies only for purposes of the regular tax. Thus, the deduction is specifically treated as a preference item for purposes of the corporate alternative minimum tax under Code §56(c)(3).[49]

In addition to the special deduction, eligible organizations will not be required to include in income 20% of unearned premium reserves annually, as is generally required of property and casualty insurance companies under Act §1021.[50] Finally, such organizations will be entitled to a

[44] A Code §501(c)(3) organization is a corporation, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, educational or certain other purpose.

[45] A Code §501(c)(4) organization is a civic league or organization not operated for profit but operated exclusively for the promotion of social welfare.

[46] Code §833(b)(1)(A)(ii).

[47] Code §833(b)(2).

[48] Code §833(b)(3).

[49] Act §701(a).

[50] Code §833(a)(3).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

special basis adjustment. Act §1012(c)(3)(A) provides that the basis of the assets of existing Blue Cross and Blue Shield organizations and certain new Blue Cross and Blue Shield organizations will be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1986. This basis step-up, which is intended to ensure that such formerly tax-exempt organizations would not be taxed on unrealized appreciation that accrued during the period the organizations were not subject to tax, is provided only for purposes of determining gain or loss upon sale or exchange of the assets.

As noted earlier, these special provisions (*i.e.*, 25% deduction, exemption from the unearned premium reserve provision, and special basis adjustment) apply only to "existing" Blue Cross and Blue Shield organizations and certain new organizations substantially all of the activities of which are providing health insurance. Code §833(c)(2) defines an "existing Blue Cross and Blue Shield organization" as one: (1) which was in existence on August 16, 1986; (2) which was tax-exempt for the last taxable year beginning before January 1, 1987; and (3) where no material change has occurred in its structure or operation after August 16, 1986. According to the Conference Report, a material change does not include a merger or split-up of one or more Blue Cross and Blue Shield organizations.[51] In addition, the Conference Report provides that:

> if an existing Blue Cross/Blue Shield organization acquires a new line of business or is acquired by another business (other than a health business), the acquisition does not constitute a material change in operations or structure of the organization if (1) the assets of the other business are a de minimis percentage (*i.e.*, less than 10%) of the assets of the existing Blue Cross/Blue Shield organization at the time of the acquisition, or (2) the taxpayer can demonstrate to the Secretary of the Treasury that, based on all the facts and circumstances, the acquisition does not constitute a material change in operations or structure of the existing Blue Cross/Blue Shield organization.[52]

A material change in operations does occur, however, if an existing Blue Cross and Blue Shield organization drops its high risk coverage or substantially changes the terms and conditions under which high risk coverage is offered by the organization from the terms and conditions in effect as of August 16, 1986. High risk coverage generally means the coverage of individuals and small groups to the extent the organization (1) provides such coverage under specified terms and conditions as of August 16, 1986, or (2) meets the statutory minimum definition of high risk coverage for new organizations discussed below. A material change in operations does not occur if an existing organization alters its operations to provide high risk coverage that meets the minimum standards required of new Blue Cross and Blue Shield organizations.

Other organizations (*i.e.*, Blue Cross and Blue Shield organizations not existing on August 16, 1986) are eligible for the special provisions outlined above if they meet six requirements set forth in Code §833(c)(3).

First, substantially all of the activities of such organizations must involve the providing of health insurance.[53]

Second, at least 10% of the health insurance (determined as a percentage of the total number of individuals covered annually) provided by the organization must be provided to individuals and small groups (not taking into account Medicare supplemental coverage).[54] Code §833(c)(3)(B) defines small group as the lesser of 15 individuals or the number of individuals required for a small group under the state law where the covered groups are located.

Third, the organization must provide continuous full-year open enrollment (including conversions) for individuals and small groups.[55]

Fourth, any individual seeking health insurance must be offered coverage which includes coverage of preexisting conditions, and the coverage must become effective within a reasonable waiting period after the time it is sought.[56] According to the Conference Report, a reasonable waiting period is intended to be not more than three months.[57] Further, health insurance coverage must be provided without regard to the age, income, or employment status of persons under age 65.

Fifth, at least 35% of the organization's health insurance premiums must be determined on a community-rated basis.[58] This percentage is determined as a percentage of the total number of persons covered on an annual basis.

Finally, the organization must be organized and operated so that no part of the net earnings inures to the benefit of any private shareholder or individual.[59]

C. Effective Date, Special Rules, and Study

In general, Act §1012(c)(1) provides that the changes made by Act §1012 (relating to repeal of tax-exempt status for certain organizations providing commercial-type insurance) are effective for taxable years beginning after December 31, 1986.

Act §1012(c)(4), however, provides that the TRA provision will not apply to certain named organizations. First, that portion of the business of Mutual of America and Teachers Insurance Annuity Association-College Retirement Equities Fund attributable to pension business will retain its tax-exempt status.[60] For this purpose, Act §1012(c)(4)(D) defines pension business to mean the administration of qualified pension plans (Code §401(a) or 403(a)), tax-sheltered annuities (Code §403(b)), unfunded

[51] H.R. Rep. No. 841, 99th Cong. 2d Sess II-347 (1986), ("Conference Report").
[52] *Id.*
[53] Code §833(c)(3)(A)(i).
[54] Code §833(c)(3)(A)(ii).
[55] Code §833(c)(3)(A)(iii).
[56] Code §833(c)(3)(A)(iv).
[57] Conference Report, p. II-350.
[58] Code §833(c)(3)(A)(v). According to the Conference Report, community rating means that premiums are determined on the basis of the average annual cost of health insurance over the population in the community.
[59] Code §833(c)(3)(A)(vi).
[60] Act §1012(c)(4)(A) and (B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

deferred compensation plans of state and local governments (Code §457), and individual retirement arrangements (Code §408).

Additional special rules provide that the TRA provision does not apply to the YMCA retirement fund, to administrative services performed by tax-exempt municipal leagues, to the Missouri Hospital Association, or to dental benefit coverage by Delta Dental Plans Association through contracts with independent service providers so long as the provision of such coverage is the principal activity of such Association.[61]

Act §1012(c)(2) requires that the Treasury Department conduct a study of fraternal beneficiary organizations (described in Code §501(c)(8)) that received gross insurance premiums in excess of $25 million in taxable 1984. The results of this study must be provided to the Ways-and Means Committee, the Finance Committee, and the Joint Committee on Taxation no later than January 1, 1988.

IV. Life Insurance Company Provisions

A. Repeal of Special Deduction

Under the 1959 Act, a life insurance company's net taxable income for any year was determined, in the case of a mutual life insurance company, after allowance of the deductible portion of policyholder dividends and, in the case of a stock company, after taking into account the deductible portion of policyholder dividends (if any), the deductible portion of the "special" deductions under former Code §§809(d)(5) and (6), and the 50% deferral of any excess of gain from operations over taxable investment income. One of the principal objectives of these provisions was to moderate the tax burden imposed on the life insurance industry.

Like the 1959 Act, the 1984 TRA was fashioned with an eye to moderating the tax burden on life insurance companies so that they would not be taxed in a manner that was disproportionate in comparison with the taxation of other financial institutions.[62] Under the 1984 Act, this was accomplished by allowing a company two deductions under Code §806: the "special life insurance company deduction" and (if applicable) the "small life insurance company deduction."

Under Code §§804(2) and 806(a), a life insurance company was entitled to a "special life insurance company deduction" equal to 20% of the excess of its "tentative LICTI" for the taxable year over the amount (if any) of its "small life insurance company deduction" for the year. A life insurance company's tentative LICTI did not take into account any items attributable to a noninsurance business. The effect of the special life insurance company deduction was to reduce the tax rate on a life insurance company's income from its insurance business from the general corporate rate of 46% to 36.8%.

The 1986 TRA amends the rate structure for corporate income by replacing the five-bracket graduated rate structure with a three-bracket graduated rate structure:

Taxable Income	Tax Rate (percent)
$50,000 or less	15
Over $50,000 to $75,000	25
Over $75,000	34

An additional 5% tax is imposed on income between $100,000 and $335,000, thereby phasing-out the benefit of graduated rates for corporations with taxable income of $335,000 or more. Thus, corporations with taxable income of $335,000 or more will pay tax at a flat rate of 34%.

Because of these rate reductions, the 1986 Act repeals the special life insurance company deduction.[63] The House Report explains that "In light of the overall reduction of corporate tax rates contained in other provisions of the bill, the committee believes that the 20% special life insurance company deduction is no longer necessary." [64]

The repeal of the special life insurance company deduction applies to taxable years beginning after December 31, 1986.[65] The post-1986 TRA corporate rate structure, however, is effective for taxable years beginning on or after July 1, 1987, and income in taxable years that include July 1, 1987 is subject to blended rates determined under Code §15. Thus, corporations with a calendar year taxable year and taxable income of $335,000 or more will pay a flat rate of 40% in 1987. In the case of a life insurance company with a calendar year taxable year and taxable income of at least $335,000, its marginal rate will increase from 36.8% for 1986 to 40% for 1987 and then go down to 34% for 1988.

B. Market Discount Bonds

Under Code §811(b)(3), a life insurance company may elect not to accrue market discount on any bond, as defined in Code §171(d). If a company makes such an election, one of the effects typically is that market discount will be taxed as a capital gain. Prior to enactment of the Act, a corporation's net capital gain was taxed at a preferential alternative rate of 28%.Thus, life insurance companies which made the election not to accrue market discount were generally able to have market discount on their bonds taxed at a 28% rate rather than a 36.8% rate. The Act,[66] however, repealed the preferential 28% rate and taxes corporate net capital gain at the same rate as other corporate income, with a maximum rate of 34%.

The Act contains a special transitional rule continuing the benefit of prior law for certain bonds held by 15 named life insurance companies.[67] Specifically, in a non-Code amendment, the Act provides that, notwithstanding the repeal of the preferential corporate capital gains rate, any gain recognized by one of the 15 named companies on the redemption at maturity of any bonds issued before July 19,

[61] Act §1012(c)(4)(C).
[62] *See, e.g.*, H.R. Rep. No. 432, 98th Cong., 2d Sess. 1407 (1984).
[63] Act §1011(a).
[64] H.R. Rep. No. 426, 99th Cong., 1st Sess. at 662 (1985), ("House Report").
[65] Act §1011(c)(1).
[66] Act §311.
[67] Act §1011(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

1984, and acquired by the company on or before September 25, 1985, "shall be subject to tax at the rate of 28 percent." [68]

C. *Operations Less Deduction of Insolvent Life Insurance Company*

Under the 1959 Act, certain amounts excluded or deducted from a stock life insurance company's taxable income were added to a deferred tax account referred to as the Policyholders Surplus Account.[69] The Policyholders Surplus Account represented amounts that were not taxed previously because they might be needed for policyholders. Under the 1984 Act, amounts are no longer added to a Policyholders Surplus Account, but Code §815(a) requires a stock life insurance company to maintain its Account. In addition, under the 1984 Act a company's tax under Code §801 is increased by any distributions to shareholders from the Policyholders Surplus Account.

The 1986 Act contains a provision [70] which allows a life insurance company that satisfies certain conditions to reduce a distribution to its shareholders from its Policyholders Surplus Account by its loss from operations and unused operations loss carryovers. The conditions which must be satisfied are: (1) the life insurance company must have been insolvent on November 15, 1985, (2) pursuant to the order of a court in a title 11 or similar case (as defined in §368(a)(3) of the 1954 Code) the company must be liquidated, and (3) as a result of the liquidation, the company's tax under Code §801 would otherwise be increased under Code §815(a). The provision is limited to liquidations which occur on or after November 15, 1985. The provision prohibits a carryover of any loss from operations of the company arising during, or prior to, the year of liquidation from being used in any subsequent taxable year. The committee reports note that this prohibition applies "regardless of whether the amount of the loss exceeds the amount of the distribution" from the Policyholders Surplus Account.[71]

D. *Alternative Minimum Tax*

Under pre-1986 TRA law, corporations were subject to a minimum tax on certain items of tax preferences.[72] The minimum tax was structured as an "add-on" tax, *i.e.*, the amount of the minimum tax liability was in addition to the corporation's regular tax liability. The minimum tax was equal to 15% of the amount by which the sum of the corporation's tax preferences exceeded the greater of $10,000 or the regular income tax the corporation paid.[73] The principal corporate tax preference items included

(1) The excess of accelerated over straight-line depreciation for real property;

(2) The excess of 60-month amortization over the otherwise allowable depreciation for certified pollution control facilities;

(3) Percentage depletion to the extent in excess of the property's adjusted basis; and

(4) 18/46ths of the corporation's net capital gain.

The 1986 Act replaced the add-on minimum tax with a revised alternative minimum tax.[74] The revised alternative minimum tax is equal to 20% of the excess of alternative minimum taxable income over the exemption amount of $40,000.[75] (The exception is reduced by 25% of the alternative minimum taxable income in excess of $150,000, and it is completely eliminated when alternative minimum taxable income equals or exceeds $310,000.) Alternative minimum taxable income consists of taxable income recomputed with certain adjustments and increased by certain items of tax preference.[76] Although the tax imposed by revised Code §55 is technically equal to the excess of the "tentative minimum tax" for the year over the regular tax for the year, the substantive effect is that a corporation will pay federal income tax equal to the greater of its alternative minimum tax or its regular tax.

The Senate Report explains that the revised minimum tax is intended to "serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits." [77] Given that one of the purposes of the extensive 1984 TRA revisions in the taxation of life insurance companies was to impose a tax on the true economic income of such companies, one might not expect the revised alternative minimum tax to affect in any significant manner the tax liabilities of life insurance companies. Nevertheless, unlike the add-on minimum tax of prior law, the revised alternative minimum tax is likely to have a substantial effect on the tax liability of a number of life insurance companies.

1. *Alternative Minimum Taxable Income — In General*

Code §55(b)(2) defines "alternative minimum taxable income" to mean a corporation's taxable income for a year "determined with the adjustments provided in §56 and §58" and "increased by the amount of the items of tax preference described in §57."

a. *Adjustments*

Code §56(a) specifies that the following adjustments are to be made by *all taxpayers* in determining alternative minimum taxable income:

(1) *Real property* placed in service after December 31, 1986, generally must be depreciated over 40 years using the straight-line method.[78]

(2) *Personal property* placed in service after December 31, 1986, generally must be depreciated using the

[68] *Id.* Under a proposed concurrent resolution correcting certain errors in the Act, this treatment would have been applicable to all life insurance companies.
[69] Former Code §815.
[70] Act §1013.
[71] House Report, *supra*, at 667; S. Rep. No. 313, 99th Cong., 2d Sess., 493 (1986), ("Senate Report").
[72] Former Code §§56, 57.
[73] Former Code §56.
[74] Act §701.
[75] Code §55(b) and (d).
[76] Code §55(b)(2).
[77] Senate Report at 518.
[78] Code §56(a)(1).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

150% declining balance method, but switching to the straight-line method in the first year in which that method would yield a higher deduction.[79]

(3) *Mining exploration and development costs* must be capitalized and amortized ratably over a 10-year period beginning with the year of the expenditure.[80]

(4) *Income from long-term contracts* entered into after March 1, 1986, must be determined under the percentage-of-completion method of accounting (as modified by Code §460(b)).[81]

(5) *In lieu of the net operating loss deduction* allowed under §172, the alternative tax net operating loss deduction (defined in Code §56(d)) must be used.[82]

(6) *Pollution control facilities* placed in service after December 31, 1986 are treated in the same manner as other personal property for purposes of determining alternative minimum taxable income.[83]

(7) *Income from installment sales* of certain property must be determined without regard to the installment method under Code §§453 or 453A and all payments to be received from the sale are deemed received in the year of the sale.[84]

Code §56(c) directs that the following adjustments are to be made by *corporations* in determining alternative minimum taxable income:

(1) *Merchant Marine Capital Construction Funds.* Alternative minimum taxable income must be computed without a deduction for contributions to a capital construction fund and the earnings on the amounts in the fund must be included in alternative minimum taxable income.[85]

(2) *Blue Cross Blue Shield Organizations* must compute their alternative minimum taxable income without the special deduction allowed with respect to their health business under Code §833(b) for 25% of the claims and expenses incurred during the taxable year, less the adjusted surplus at the beginning of the year.[86]

(3) *Book Income or Adjusted Earnings and Profits.* Alternative minimum taxable income must be adjusted (1) for "book income" for taxable years beginning in 1987, 1988 and 1989, and (2) for "adjusted earnings and profits" for taxable years beginning after 1989. These two adjustments are discussed, *infra*.[87]

b. Items of Tax Preference

Code §57 specifies that the following items are to be treated as items of tax preference which must be added to a corporation's taxable income:

(1) *Percentage Depletion.* The excess of the percentage depletion deduction over the adjusted basis of the property.[88]

(2) *Intangible Drilling Costs.* Excess intangible drilling costs to the extent they exceed 65% of net income from oil, gas, and geothermal properties. Excess intangible drilling costs equal the excess of intangible drilling costs paid or incurred and deducted over the amount that would have been deductible if such costs had been capitalized and amortized over 10 years.[89]

(3) *Bad-debt Reserves.* The excess of the bad-debt deduction allowed over the amount that would have been deductible if actual experience had been used.[90]

(4) *Tax-exempt Interest.* Interest on specified private activity bonds reduced by any deduction which would have been allowable if the interest were includible in gross income.[91]

(5) *Charitable Contribution of Appreciated Property.* The excess of the charitable contribution deduction under Code §170 over the amount that would be allowed if the deduction for capital gain property were taken into account at its adjusted basis.[92]

(6) *Depreciation.* For real property placed in service prior to January 1, 1987, the excess of accelerated over straight-line depreciation, using the useful life appropriate for the year the property was placed in service, is a preference item. The preference for personal property, placed in service prior to January 1, 1987, is unchanged by the Act.[93]

c. Alternative Minimum Tax Credit

To prevent a taxpayer from being taxed twice on the same transaction, where the regular tax liability of a corporation exceeds its alternative minimum tax liability, the corporation is allowed to credit against such excess the alternative minimum tax paid in prior years. Such minimum tax credit may be carried forward indefinitely, but may not be carried back.[94]

2. Alternative Minimum Tax — The Book Income Adjustment

For any taxable year beginning in 1987, 1988, or 1989, the alternative minimum taxable income of a corporation will be adjusted to include 50% of the excess of the "adjusted net book income" of the corporation over its alternative minimum taxable income for the taxable year (determined without regard to the book income adjustment and the alternative tax net operating loss deduction).[95] The "adjusted net book income" of a corporation equals the net income (or loss) of the corporation which is set forth in the corporation's "applicable financial statement," taking into account certain adjustments.[96]

[79] *Id.*
[80] Code §56(a)(2).
[81] Code §56(a)(3).
[82] Code §56(a)(4).
[83] Code §56(a)(5).
[84] Code §56(a)(6).
[85] Code §56(c)(2).
[86] Code §56(c)(3).
[87] Code §56(c)(1).
[88] Code §57(a)(1).
[89] Code §57(a)(2).
[90] Code §57(a)(4).
[91] Code §57(a)(5).
[92] Code §57(a)(6).
[93] Code §57(a)(7).
[94] Code §53.
[95] Code §56(f)(1).
[96] Code §56(f)(2)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

a. The Applicable Financial Statement

A corporation's financial statement is generally expected to include an income statement, a balance sheet setting forth the amount of the corporation's assets, liabilities and owners' equity, a statement of changes in owners' equity, and other appropriate information.[97] In the case of a corporation which has more than one financial statement, *e.g.*, a statement computed under generally accepted accounting principles and an NAIC annual statement, the statute establishes rules of priority for determining which financial statement is to be considered the "applicable financial statement."

Specifically, Code §56(f)(3) provides that the highest priority shall be given to a financial statement filed with the Securities and Exchange Commission.[98] Thus, the applicable financial statement for a stock life insurance company, the stock of which is publicly traded, will be the financial statement the company files with the SEC. The next highest priority is accorded to a "certified audited income statement" to be used for purposes of a statement or report (1) for credit purposes, (2) to shareholders, or (3) for any substantial nontax purpose.[99] If a corporation has certified audited income statements prepared for more than one of these enumerated purposes, priority is given to the statement serving the purpose first listed, *e.g.*, a statement for credit purposes takes precedence over a statement to shareholders.[100] A financial statement is considered to be "certified" for these purposes "if it is accompanied by an opinion of a professional accountant stating that the financial statement generally is consistent with the taxpayer's accounting principles."[101] Thus, the applicable financial statement for a life insurance company which does not file a statement with the SEC but which does have a financial statement prepared in accordance with generally accepted accounting principles will be the GAAP financial statement. In either event, however, the applicable financial statement will be one which will have capitalized and amortized policy acquisition expenses, in contrast to the current expensing of such items in computing regular taxable income. The consequence of this will vary from company to company but, for a growing company, the result generally will be that alternative minimum taxable income will be higher than regular taxable income. Note also that, in the case of a company eligible for the small company deduction under Code §806, that deduction will not be present in the applicable financial statement, thereby further increasing any differential between alternative minimum taxable income and regular taxable income.

The third highest priority is given to "an income statement required to be provided to" (1) the federal government or a federal agency, (2) a state government or a state agency, and (3) a political subdivision of a state or an agency thereof.[102] If a corporation has none of the above financial statements, then the applicable financial statement is an income statement used for the purposes of a statement or report (1) for credit purposes, (2) to shareholders, or (3) for any other substantial nontax purpose.[103] Thus, a life insurance company which files neither an income statement with the SEC nor a certified audited income statement, *e.g.*, a mutual life insurance company, will generally use as its applicable financial statement its NAIC annual statement. In this regard, the Conference Report states that "[i]n the case of an insurance company whose applicable financial statement is the financial statement prepared for regulatory purposes, the conferees intend that the measure of pre-tax book income is the amount of net gain from operations after dividends to policyholders and before Federal income taxes."[104]

b. Adjustments to Net Book Income

After having identified a corporation's applicable financial statement, certain specified adjustments must be made to the net book income (or loss) set forth in such statement.[105] The adjustments are as follows:

1. Income Taxes

Net book income must be adjusted to eliminate federal income taxes and income, war profits, or excess profit taxes imposed by any foreign country or U.S. possession which are taken into account as either income or expense items on the applicable financial statement. To the extent that a corporation does not claim a foreign tax credit under Code §901, however, and thus deducts any foreign or U.S. possession taxes, such taxes will not be eliminated from the applicable income statement.[106] The Senate Report states that "[a]ny provision for state and local taxes is considered allowable" and that no adjustment is to be made to remove these items from the applicable financial statement.[107]

2. Related Corporations

If a taxpayer files a consolidated federal income tax return, the taxpayer's adjusted net book income for that year will take into account items from the corporations with which the taxpayer files the consolidated tax return, irrespective of whether the taxpayer files a consolidated financial statement with those corporations. Similarly, if a taxpayer's applicable financial statement is consolidated with the financial statement of other corporations with which it does not file a consolidated tax return, the taxpayer's adjusted net book income for that year will not take into account items from those corporations.[108] The Senate Report explains with respect to this adjustment that:

> it is anticipated that this adjustment will be accomplished by removing the net income and any related consolidating eliminations of companies that are included for financial statement purposes but not for Federal

[97] Senate Report at 530.
[98] Code §56(f)(3)(A)(i).
[99] Code §56(f)(3)(A)(ii).
[100] Code §56(f)(3)(C).
[101] Senate Report at 530.
[102] Code §56(f)(3)(A)(iii). If a corporation has income statements prepared for more than one type of government, priority is given to the statement prepared for the government first listed. Code §56(f)(3)(C).
[103] Code §56(f)(3)(A)(iv). Here too, if a corporation has income statements prepared for more than one of these enumerated purposes, priority is given to the statement serving the purpose first listed. Code §56(f)(3)(C).
[104] Conference Report, p. II-273.
[105] Code §56(f)(2)(B)-(H).
[106] Code §56(f)(2)(B).
[107] Senate Report at 533.
[108] Code §56(f)(2)(C)(i).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

income tax purposes, and by adding in the net income and related consolidating eliminations of companies that are excluded for financial statement purposes but included for Federal income tax purposes. In determining the consolidating eliminations of companies included for Federal income tax purposes but not for financial statement purposes, the method of consolidation that the taxpayer normally uses for financial statement purposes will be followed.[109]

A special rule is also provided with respect to dividends from related corporations. If a corporation is not included on a consolidated return with the taxpayer, the taxpayer's adjusted net book income is to take into account the earnings of such other corporation only to the extent of the dividends the taxpayer receives from such other corporation and other amounts with respect to the earnings of such other corporation that are properly includible in gross income.[110] The Senate Report states that "[i]f the taxpayer includes its ownership of the other corporation for financial purposes using another method, such as by consolidation or by the equity method, an adjustment to reverse the inclusion of the other corporation is required." [111] According to the Senate Report, the nature of the reversing adjustment depends on whether the taxpayer includes its ownership of the other corporation in its financial statement under the consolidation method or the equity method.[112] In the former case, the contribution to book income of the corporation which has not been included in the consolidated tax return is reversed by removing the net income and any consolidating eliminations of the corporation.[113] In the latter case, where the corporation is not consolidated in either the tax return or in the financial statement, but the taxpayer's interest is accounted for by use of the equity method, the Senate Report explains that "the taxpayer's net book income is adjusted to remove the effect of the corporation's inclusion under the equity method." [114]

c. Statements Covering Different Periods

Code §56(f)(2)(D) provides that "appropriate adjustments" to net book income should be made if the applicable financial statement covers a period other than the taxable year. The Senate Report explains that the financial accounting and tax accounting years should be conformed by requiring the corporation "to include a pro rata portion of each financial statement accounting year that includes the Federal income tax taxable year." [115]

d. Miscellaneous Adjustments to Net Book Income

Net book income must also be adjusted with respect to patronage dividends,[116] dividends received from corporations eligible for the Code §936 credit,[117] and certain other items in the case of Alaska Native Corporations.[118] In addition, the Secretary of the Treasury is granted authority to issue regulations to prevent the omission or duplication of any item in the computation of adjusted net book income.[119] The Senate Report gives several examples of areas in which it is anticipated that this authority will be exercised, including (1) to prevent charging items directly to the financial statement asset, liability, or equity accounts where the items are properly includible as items of income or expense, and (2) to prevent the use of asset, liability or equity accounts to offset items of income or expense where such treatment would not otherwise be allowed.[120]

3. Alternative Minimum Tax — Adjusted Current Earnings

For taxable years beginning after 1989, the book income adjustment will be replaced with a current earnings adjustment. Specifically, starting in 1990, the alternative minimum taxable income of a corporation will be *increased* by 75% of the excess (if any) of (1) the "adjusted current earnings" of the corporation over (2) the alternative minimum taxable income (determined without regard to this adjustment and the alternative tax net operating loss deduction).[121] Further, the alternative minimum taxable income of a corporation will be *decreased* by 75% of the excess (if any) of (2) over (1).[122] Any such decrease, however, cannot exceed the excess (if any) of (1) the aggregate increases in alternative minimum taxable income under the current earnings adjustment for prior taxable years over (2) the aggregate decreases in alternative minimum taxable income pursuant to the preceding sentence for prior taxable years.[123] The Conference Report explains that, for these purposes, a "positive amount is always considered to be in excess of a negative amount and a smaller negative amount in excess of a larger negative amount." [124]

"Adjusted current earnings" is defined in Code §56(g)(3) to mean alternative minimum taxable income for the taxable year determined after taking into account specified adjustments and without taking into account the current earnings adjustment and the alternative tax net operating loss deduction.[125] Thus, in general, adjusted current earnings are computed using the same treatment that an item receives in computing alternative minimum taxable income, except for specified additional adjustments. These adjustments are as follows.

a. Inclusion of Items Included in E&P

Items of income that are included in the computation of earnings and profits for purposes of Subchapter C of the Code but which are not otherwise includible in alternative minimum taxable income are includible in determining adjusted current earnings.[126] Two examples listed in the Conference Report are interest on tax-exempt bonds and the portion of dividends excluded under the dividends received deduction.[127] Expenses that are not allowable for

[109] Senate Report at 532.
[110] Code §56(f)(2)(C)(ii).
[111] Senate Report at 532.
[112] *Id.* at 532-533.
[113] *Id.*
[114] *Id.* at 533.
[115] *Id.* at 533.
[116] Code §56(f)(2)(E).
[117] Code §56(f)(2)(F).
[118] Code §56(f)(2)(G).
[119] Code §56(f)(2)(H).
[120] Senate Report at 534.
[121] Code §56(g)(1).
[122] Code §56(g)(2)(A).
[123] Code §56(g)(2)(B).
[124] Conference Report, p. II-274-75.
[125] Code §56(g)(3).
[126] Code §56(g)(4)(B)(i).
[127] Conference Report, p. II-275.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

alternative minimum tax purposes because they relate to income not includible in alternative minimum taxable income will be allowed in computing adjusted current earnings where the income to which the expenses relate are includible in determining adjusted current earnings.[128] For example, interest on tax-exempt bonds is includible in computing adjusted current earnings, and therefore the costs incurred to carry tax-exempt bonds are allowable as a deduction.[129] If, however, the deduction for such carrying costs would be subject to limitations in the computation of taxable income even if the income to which they relate were fully taxable, the Conference Report states that the costs will be similarly limited in computing adjusted current earnings.[130] The Conference Report also states that, for purposes of computing adjusted current earnings, the original issue discount rules and the market discount rules applicable to taxable bonds will apply to tax-exempt bonds.[131]

b. Inclusion of Inside Buildup

Code §56(g)(4)(B)(ii) specifically requires that the inside buildup of life insurance and annuity contracts be included in adjusted current earnings. In the case of a life insurance contract, adjusted current earnings will include "the income on such contract" for the taxable year determined under Code §7702(g), but with a deduction allowed for the "portion of any premium which is attributable to insurance coverage." [132] Code §7702(g) provides rules for the taxation of the inside buildup of a life insurance policy which fails to qualify as a life insurance contract for federal tax purposes. "Income on the contract" for purposes of Code §7702(g) includes the "cost of life insurance protection provided under the contract during the taxable year," and this cost is determined under Code §7702(g)(1)(D). Code §7702(g)(1)(D) provides that the cost of life insurance protection is the lesser of (1) the cost of insurance determined on the basis of premiums (computed on the basis of five-year age brackets) to be prescribed by regulations and (2) the mortality charge (if any) stated in the contract. Presumably, for purposes of determining adjusted current earnings, the "portion of any premium which is attributable to insurance coverage," and for which a deduction is allowed, will be deemed equal to the "cost of life insurance protection" determined under Code §7702(g)(1)(D). The effect of this would be to require the inclusion in adjusted current earnings of the increase in the life insurance contract's net surrender value during the year. (Net surrender value for purposes of §7702(g), and thus for purposes of determining adjusted current earnings also, equals the contract's cash value reduced by any applicable surrender charges.) [133]

In the case of an annuity contract, adjusted current earnings will include "the income on such contract" for the taxable year determined under Code §72(u)(2).[134] §72(u)(2), which was added to the Code by the Act, provides rules for the taxation of the inside buildup of an annuity contract which is not held by a natural person. The operation of this provision is discussed, *infra*, at V, C, 1.

c. Acquisition Expenses and the Small Company Deduction

A special rule requires that, in computing adjusted current earnings, the acquisition expenses of life insurance companies be capitalized and amortized in accordance with generally accepted accounting principles.[135] The Conference Report clarifies that such treatment should be in accordance with the method generally required (at the time the costs are incurred) by the Financial Accounting Standards Board.[136] If the FASB has not published such a method, however, guidelines issued by the American Institute of Certified Public Accountants should be followed.[137] The Conference Report also explains that, in calculating adjusted current earnings, it is to be assumed that a life insurance company's acquisition expenses have been capitalized and amortized in accordance with this provision in prior years, *i.e.*, a "fresh start" is provided.[138] Finally, the Conference Report states that, in computing adjusted current earnings, the small life insurance company deduction under Code §806 is not available.[139]

d. Disallowance of Items Not Deductible for E&P Purposes

In determining adjusted current earnings, no deduction is allowed for any item if the item would not be deductible in computing earnings and profits for purposes of Subchapter C.[140] The Conference Report cites as an example of this rule that the dividends received deduction generally is not allowed in determining adjusted current earnings.[141] An exception is made for deductions allowed under Code §§243 or 245 for a 100% dividend if the corporation paying such dividend and the corporation receiving such dividend could not file a consolidated return because of Code §1504(b).[142] The exception is limited, however, to the extent that the 100% dividend "is attributable to income of the paying corporation which is subject to tax under [chapter 1 of the Code] (determined after the application of §§936 and 921)." [143] This exception should be available to insurance companies which are precluded from filing a consolidated return by reason of Code §1504(b)(2).

e. Miscellaneous Adjustments

Several other adjustments must be made in determining adjusted current earnings. First, for property placed in service after 1989, depreciation is computed using the slower of the method used in the corporation's applicable financial statement or straight-line depreciation over the ADR midpoint life.[144] Other rules apply to property placed

[128] Code §56(g)(4)(B)(i).
[129] Conference Report, p. II-275.
[130] *Id.*
[131] *Id.*
[132] Code §56(g)(4)(B)(ii).
[133] Code §7702(f)(2)(B).
[134] Code §56(g)(4)(B)(iii).
[135] Code §56(g)(4)(F).
[136] Conference Report, p. II-277.
[137] *Id.*
[138] *Id.*
[139] *Id.*
[140] Code §56(g)(4)(C)(i).
[141] Conference Rport, p. II-275.
[142] Code §56(g)(4)(C)(ii).
[143] *Id.*
[144] Code §56(g)(4)(A).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

in service before 1989.[145] Second, no loss will be recognized on the exchange of pools of substantially similar debt pool obligations for purposes of adjusted current earnings.[146] Finally, a rule is provided for intangible drilling costs, and the special adjustments to earnings and profits under Code §312(n), *e.g.*, for construction period carrying charges, generally are made applicable to the computation of adjusted current earnings.[147]

4. Alternative Minimum Tax Treasury Department Study

The Act directs the Secretary of the Treasury to conduct a study of the operation and effects of the book income and current earnings and profits adjustments.[148] The study is to be completed by January 1, 1989.[149]

E. Technical Corrections — Reserves

1. Contracts Without Life Contingencies

Under the 1984 Act, net increases or decreases in reserves are taken into account in computing life insurance company taxable income (LICTI).[150] Included in the items for which increases or decreases are taken into account in computing LICTI are amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (at the time with respect to which the computation is made) life, accident, or health contingencies.[151] The Act provides that, in computing the increases or decreases of such discounted amounts not involving life contingencies, the amount taken into account for any contract will not be less than the net surrender value of the contract.[152] The Senate Report states, however, that, as is the case with life insurance reserves, "the amounts taken into account cannot exceed the amounts that would be taken into account with respect to such contract as of such time in determining statutory reserves (as defined in §809(b)(4)(B))."[153]

2. Contracts Without Standard Tables

Under the 1984 Act, the "prevailing commissioners' standard table" with respect to a contract means the most recent commissioners' standard table prescribed by the NAIC which is permitted to be used in computing reserves for that type of contract by 26 states at the time the contract is issued.[154] If a prevailing commissioners' standard table as of any January 1 (the "year of change") differs from the prevailing table as of the preceding January 1, the "old" table may be used with respect to contracts issued during the three-year period beginning on January 1 of the year of the change.[155]

The 1984 Act also provided that, if there are no commissioners' standard tables applicable to a contract when it is issued, the mortality and morbidity tables to be used in computing the federally prescribed reserve under Code §807(d)(2) is to be determined under regulations.[156]

The 1986 TRA provides that, when the regulations change the table applicable to a contract, the "new" table is to be treated (for purposes of the "three-year rule" and for purposes of determining the contract's issue date) as if it were a new prevailing commissioners' standard table adopted by the 26th state as of the date specified in the regulations, although no earlier than the date the regulation making the change is issued.[157]

3. Election Not to Have Reserves Recomputed

Under the 1984 Act, certain small life insurance companies may elect to have their Code §807(c)(1) reserves for contracts issued after the beginning of their first taxable year commencing after December 31, 1983, and before January 1, 1989, equal their annual statement reserves for the contracts (with a modification similar to the geometric Menge formula in effect under TEFRA). This provision of the 1984 Act applies only to a company with tentative LICTI at or below $3,000,000 and assets (taking affiliates into account) at or below $100,000,000.[158]

The 1986 TRA amends this election to specify that, in determining whether a company is eligible to make the election, the company must compute its tentative LICTI taking into account reserves as though the election were in effect.[159] In addition, the Act clarifies that the geometric Menge adjustment should be applied to opening and closing statutory reserves in computing net increases or decreases in life insurance reserves.[160] Finally, the Act provides that, if a company makes the election, its reserve for a contract will be the greater of the statutory reserve, as adjusted by the geometric Menge formula, or the net surrender value of the contract.[161]

4. Net Level Reserves for Non-Cancellable A&H Contracts

Under the 1984 Act, the federally prescribed reserve for a noncancellable accident and health insurance contract must be computed using a two-year full preliminary term method.[162] The 1984 Act, however, contained an exception to this rule which treated a company as meeting the federally prescribed reserve method with respect to a noncancellable accident and health insurance contract for a taxable year if the company (1) uses the net level reserve method to compute its tax reserves on such contracts for that taxable year, (2) was using the net level reserve method to compute its statutory reserves on such contracts as of December 31, 1982, and (3) has continuously used such method for computing such reserves on such contracts after December 31, 1982, and through such taxable year.[163]

[145] *Id.*
[146] Code §56(g)(4)(E).
[147] Code §56(g)(4)(D).
[148] Act §702.
[149] Conference Report, p. II-279.
[150] Code §807(a), (b).
[151] Code §807(c)(3).
[152] Act §1821(a).
[153] Senate Report at 964.
[154] Code §807(d)(5)(A).
[155] Code §807(d)(5)(B).
[156] Code §807(d)(5)(C).
[157] Act §1821(s).
[158] 1984 Act §216(c)(2).
[159] Act §1822(c)(1).
[160] Act §1822(c)(3).
[161] Act §1822(c)(2).
[162] Code §807(d)(3)(A)(iii).
[163] 1984 TRA §217(n).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The Committee Reports explain that, because the provision contained in the 1984 Act "is impractically narrow, and would not result in any taxpayer making the election," the provision has been modified.[164] Under the 1986 Act, the exception will apply to any directly written noncancellable accident and health insurance contract (whether under an existing or new plan of insurance) written by a company if (1) the company used the net level reserve method to compute at least 99% of its statutory reserves on such contracts as of December 31, 1982, (2) the company received more than half its total direct premiums in 1982 from directly written noncancellable accident and health insurance, (3) after December 31, 1983, the company has continuously used the net level reserve method for at least 99% of its tax and statutory reserves on such contracts, and (4) for any such contract for which the company does not use the net level reserve method, the company uses the same method for computing tax reserves and for computing statutory reserves.[165]

F. Technical Corrections — Ownership Differential

1. Equity Base

Code §809(b)(2) defines the equity base for purposes of determining the Code §809 differential earnings amount as a company's surplus and capital increased by (1) nonadmitted financial assets, (2) the excess of statutory reserves over tax reserves, (3) the amount of any mandatory securities valuation reserve, (4) the amount of any deficiency reserve, (5) the amount of any voluntary reserve or similar liability, and (6) 50% of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year. The Act amends Code §809(b)(2) to clarify that no item shall be taken into account more than once in determining a company's equity base.[166] The committee reports explain that this "clarification is made to ensure that items which are specifically included in the equity base are not counted a second time because they may be indirectly included under another item which is included in the equity base." [167]

2. Definition of 50 Largest Stock Companies

The Act modifies in several respects the Secretary's authority under Code §809(d)(4)(C) to exclude companies from the 50 largest stock companies.[168] First, the Act requires any company with a negative equity base to be excluded from the 50 largest stock companies, both for purposes of determining the base period stock earnings rate and for purposes of determining the current stock earnings rate. Second, the authority of the Secretary to exclude by regulation additional companies from the 50 largest stock companies if the inclusion of those companies would, because of the small equity base of the companies, seriously distort the stock earnings rate, is modified to limit the number of companies which could be excluded because of their distorting effects. Specifically, if no company were excluded from the 50 largest stock companies because of a negative equity base, a maximum of two distorting companies could be excluded; if one company with a negative equity base were excluded, one distorting company could be excluded; and if two or more companies with negative equity bases were excluded, no distorting companies could be excluded.

3. Domestic Companies Only

The Act also amends the definition of the "50 largest stock companies" to exclude from that group any foreign stock life insurance company.[169] In addition, the Act specifies that only domestic mutual life insurance companies shall be taken into account in determining the average mutual earnings rate.[170]

4. Statement Gain or Loss from Operations

Under the 1984 Act, a company's "statement gain or loss from operations" for purposes of Code §809 means the company's net gain or loss from operations set forth in its annual statement (1) determined with regard to policyholder dividends, as defined in Code §809, but without regard to federal income taxes, (2) determined on the basis of tax reserves rather than statutory reserves, and (3) properly adjusted for realized capital gains and losses and other relevant items.[171] The Act amends the definition of statement gain or loss from operations to specify that the net gain or loss from operations in the annual statement must be determined by substituting for the amount shown for policyholder dividends on the annual statement the amount of the deduction for policyholder dividends determined under Code §808 prior to the reduction of such amount by the differential earnings amount determined under Code §809.[172]

5. Estimated Taxes

Under the 1984 Act, the differential earnings amount is equal to a mutual life insurance company's average equity base for the taxable year, multiplied by the differential earnings rate for such taxable year.[173] The differential earnings rate for a taxable year is the excess of the imputed earnings rate for the taxable year over the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.[174] The Secretary of the Treasury publishes the differential earnings rate after collecting all the data upon which computation of the rate depends. In addition, under the 1984 Act the differential earnings amount for a year is recomputed when the Secretary has received sufficient tax return information to determine the differential earnings rate for that year on the basis of the average mutual earnings rate for that year.[175]

The Act makes two changes to prevent imposition of additions to tax under Code §6655 for underpayments of estimated taxes as a consequence of the operation of Code §809. First, the Act provides that, for purposes of determin-

[164] Senate Report at 983; House Report at 963.
[165] Act §1823.
[166] Act §1821(d).
[167] Senate Report at 968; House Report at 948.
[168] Act §1821(e).
[169] Act §1821(e)(2)(A).
[170] Act §1821(e)(2)(B).
[171] Code §809(g)(1).
[172] Act §1821(f).
[173] Code §809(a)(3).
[174] Code §809(c)(1).
[175] Code §809(f).

ing compliance with the installment payment requirements for estimated taxes under Code §6655, the amount of tax shall be determined by using the lesser of (1) the differential earnings rate for the second taxable year preceding the taxable year for which the installment is made, or (2) the differential earnings rate for the taxable year for which the installment is made.[176] Second, the Act provides that, if a mutual life insurance company's income tax liability for a taxable year is increased (or decreased) as a result of the recomputed differential earnings rate, the company's liability for estimated tax payments for that taxable year will not be affected by that increase (or decrease).[177]

6. High Surplus Mutual

The 1984 Act contained a special transition rule for mutual life insurers which had more surplus in relation to their assets than was characteristic of the mutual segment of the industry. Under Code §809(i), in the case of such a "high surplus" mutual life insurance company no differential earnings amount is computed with respect to a portion of the company's "excess equity base." Code §809(i)(2) defines such excess equity base. The Act provides that in the case of a certain mutual life insurance company, the amount of the company's excess equity base will equal $175,000,000. *See* Act §1821(q).

G. Technical Corrections — Proration

Under the 1984 Act, as under prior law, net investment income must be allocated between the company's share and the policyholders' share. Net investment income equals 90% of gross investment income. The company's share of net investment income is the excess (if any) of net investment income over the sum of (1) required interest at the prevailing state assumed rate for Code §807(c) reserves (other than unearned premiums and unpaid losses); (2) the deductible portion of excess interest; (3) the deductible portion of amounts not taken into account under (1) or (2) which are credited to a policyholder's fund under a pension plan contract for employees (except retired employees) or to a deferred annuity contract before the annuity starting date; and (4) a fraction (the "minifraction") of the deductible portion of policyholder dividends, but not including the deductible portion of any amounts included under (2) or (3), and not including the deductible portion of the premium and mortality charge adjustments under contracts paying excess interest during the taxable year.

The numerator of the minifraction is gross investment income for the taxable year, less the amounts taken into account under (1), (2), and (3). (Items (1), (2), and (3) are referred to as "policy interest.") The denominator of the minifraction is life insurance gross income (including tax-exempt interest) less the increase (if any) in Code §807(c) reserves. *See* Code §812.

Although the deduction for dividends received is prorated between the company and its policyholders in the manner described above, "100% dividends" are not so prorated. In general, "100% dividends" are dividends received from subsidiaries more than 80% owned by the life insurance company. However, 100% dividends are subject to proration to the extent that the dividends themselves are derived (wholly or in part) from tax-exempt interest or dividends that are not 100% dividends at the paying subsidiary's level.

The Act makes a number of technical corrections to these proration provisions. First, the Act amends the definition of required interest on reserves for purposes of determining the company's share of net investment income to provide that, where a company has not used the prevailing state assumed rate "another appropriate rate" is to be used.[178] The Act also adds to the items included in policy interest interest on amounts left on deposit with the company.[179] The committee reports cite as an example of this item "interest paid on deposit administration contracts that provide no permanent purchase rate guarantees . . . ."[180]

The Act redefines the denominator of the minifraction to eliminate a circularity problem in the computation.[181] The definition of net investment income is also amended to provide that, in the case of gross investment income attributable to assets held in segregated asset accounts for variable contracts, net investment income equals 95% of gross investment income.[182] The Act provides several special rules for interest received by a life insurance company with respect to a securities acquisition loan as defined in Code §133(b). Specifically, interest received from such ESOP loans is not to be included in either "gross investment income" or "tax-exempt interest" for purposes of the proration formula or for purposes of computing net increases or decreases in reserves under Code §807(a) and (b).[183] In addition, interest on such loans is not includible in life insurance gross income for purposes of the mini-fraction's share of the deductible portion of policyholder dividends.[184] The Act also restores a rule of prior law with respect to treatment of dividends within an affiliated group filing a consolidated return. This rule requires that a company compute its policyholders' share of net investment income as if the company had not filed a consolidated return.[185] Finally, the Act adds a special rule to prevent the "double proration" of 100% dividends received from an insurance company subsidiary.[186]

H. Technical Corrections — Variable Contracts

1. Variable Life: The "Look Through" Rule

Under the 1984 Act, the investments in a segregated asset account underlying variable life insurance contracts and variable annuity contracts must be adequately diversified for the contracts to be treated as life insurance contracts or annuity contracts, respectively. Code §817(h) provides a statutory safe-harbor for diversification, a special rule for variable life insurance contracts based on a segregated asset account investing in United States Treasury obligations, and a special rule for investments in

[176] Act §1821(g).
[177] Act §1821(h).
[178] Act §1821(i)(1); Code §812(b)(2)(A).
[179] Act §1821(i)(1); Code §812(b)(2)(D).
[180] Senate Report at 972; House Report at 952.
[181] Act §1821(i)(2); Code §812(b)(3)(B).
[182] Act §1821(i)(3); Code §812(c).
[183] Act §1821(i)(4); Code §812(g).
[184] *Id.*
[185] Act §1821(o); Code §818(e).
[186] Act §1821(p); Code §805(a)(4).

regulated investment companies or trusts which allow investments only by insurance companies or segregated asset accounts. Under this last rule, the "look through" rule, a segregated asset account is treated as owning a pro-rata share of the underlying investments in the regulated investment company or trust.

The Act clarifies the special rule for variable life insurance contracts based on segregated asset accounts which invest in securities issued by the United States Treasury.[187] The Act provides that, with respect to such contracts, the segregated asset account will be treated as adequately diversified to the extent it is invested in securities issued by the United States Treasury.[188] The Act broadens the look-through rule to allow shares or units of an underlying fund to be held by the general account of an insurance company or by a fund manager.[189] Thus, the look-through rule will continue to apply as long as all the units or shares of the underlying fund are held by (1) insurance companies or affiliated companies, or (2) fund managers or affiliated companies, in connection with the creation or management of the regulated investment company or trust.

2. Variable Contracts with Guarantees

In recent years, insurers have developed annuity and pension plan contracts that combine separate account features with guarantees. Net premiums paid for such contracts are placed in a separate account and the amount paid in, or the amounts paid out, vary directly with the investment return and market value of the separate account assets. Additionally, these contracts provide that if assets in the account are insufficient to meet stated guarantees, the insurer will make payments from the general account to satisfy the guarantees.

Questions had arisen concerning whether, because of the guarantees, such contracts satisfied the condition for variable contract treatment contained in Code §817(d)(3)(A) which requires, in the case of an annuity contract, that the amounts paid in, or the amounts paid out, reflect the investment return and market value of the segregated asset account. In addition, assuming such contracts were described in Code §817(d), questions arose concerning the proper tax treatment of the contracts where the assets in the account became insufficient to satisfy the insurer's liability for amounts guaranteed under the contracts.

The Act amends Code §817(d) to resolve these issues.[190] The Act provides that variable contracts will be taxed in accordance with the rules of §817 even though the contracts contain guarantees. Thus, the amendment assures that such contracts will continue to be accounted for in accordance with Code §817 where, because of the guarantees, the insurer's total obligation under the contract exceeds the value of the separate account assets. In addition, the amendment clarifies that in such situations the portion of the total obligation attributable solely to the guarantees will be accounted for as part of the general account. Under a special effective date rule, this amendment applies to contracts issued after December 31, 1986 and, if the contract was treated as a variable contract on the company's tax return, to contracts issued before January 1, 1987.[191]

I. Technical Corrections — Fresh Start

1. In General

Under the 1984 Act, a life insurance company (except for purposes of qualification) was required to compute its reserves for its first taxable year beginning after December 31, 1983, as if the federal reserve standards under the 1984 Act applied with respect to all then-existing contracts when they were issued. Absent special relief, this provision would have caused virtually all companies to have experienced income (from the reserve decrease). To avoid such a problem, the 1984 Act provided, as a general rule, that any change in reserve (or accounting) methods attributable solely to the 1984 Act was not to be treated as a change in reserve (or accounting) method.[192] Thus, a "fresh start" was provided, and the flow of reserve decreases into gross income was precluded. The fresh start, however, did not apply to certain reserves, including (a) any reserve transferred pursuant to a reinsurance agreement entered into, or modified, after September 27, 1983, and before January 1, 1984, and (2) any reserve subject to a "reserve strengthening" reported for federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984. The 1984 Act also changed the deduction for dividends to policyholders from the amount of policyholder dividends paid during the taxable year plus the increases (or less the decreases) in the reserve for policyholder dividends that were payable during the year following the taxable year to the amount of policyholder dividends paid or accrued during the taxable year.[193] Under the fresh start rule, this change in the policyholder dividend deduction was not treated as a change in method of accounting and companies received a fresh start in computing that deduction. The Act makes several changes with respect to the fresh start provisions of the 1984 Act.

2. Accelerated Policyholder Dividends

First, the Act amends Code §808 to add a provision which limits the benefits of the fresh-start adjustment by reducing a company's deduction for policyholder dividends (prior to any differential earnings amount reduction under Code §809) if the company accelerates its policyholder dividends by changing its business practices. Specifically, a company's policyholder dividend deduction is reduced by the amount of the "accelerated policyholder dividends deduction," but not in excess of the "1984 fresh start adjustment for policyholder dividends." The latter amount is, in general, the amount held at year-end 1983 as a reserve for dividends to policyholders, but reduced by dividends which had accrued by that date and by dividends which would not have deductible under former Code §809(f). With respect to the "accelerated policyholder dividends deduction," the committee reports explain that:

> The term "accelerated policyholder dividends deduction" means the amount that would be determined for

[187] Act §1821(m).
[188] Code §817(h)(3).
[189] Code §817(h)(4).
[190] Act §1821(t).
[191] Act §1821(t)(2).
[192] 1984 Act §216(b).
[193] Code §808(c).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the taxable year as policyholder dividends paid or accrued, but which would have been determined for a later taxable year under the business practices of the company as in effect at the close of the preceding taxable year. Thus, the types of changes in business practices that would result in an accelerated policyholder dividends deduction include guaranteeing of policy dividends on termination for a particular product line or changing the actual payment date of policy dividends (for example, by making such dividends available upon declaration). On the other hand, changes in plans of insurance being sold or the development of new products will not be treated as resulting in an accelerated policyholder dividends deduction. For example, the introduction and sale of a universal life insurance product that credits excess interest to the cash surrender value on a monthly basis and that may depart from prior business practices of selling traditional participating life insurance policies that pay policy dividends at the policy anniversary date is not the type of change in business practice covered by this provision.[194]

The 1986 TRA limitation does not apply (1) to a simple change in the amount of policyholder dividend, *e.g.*, a change in dividend scale, (2) to policyholder dividends with respect to a policy issued after December 31, 1983, and (3) to policyholder dividends with respect to group policies issued in connection with employee welfare benefit plans.[195]

3. Other Changes With Respect to Fresh Start

The Act clarifies that with respect to reserves for which a fresh start is denied, *e.g.*, a reserve transferred by a reinsurance agreement, the change is to be taken into account under the 10-year spread of Code §807(f) if such amount would have been taken into account over 10 years under former Code §810(d).[196] The Act also clarifies the treatment of reserves which were subject to the former Code §818(c) election after September 27, 1983, and which were excepted from the 1984 Act rule providing that such elections generally were ineffective.[197] In addition, the Act provides a further exception to such rule.[198] The Act also clarifies the application of the 1984 Act's limitation on fresh start with respect to reserves transferred pursuant to reinsurance transactions in the case of a reinsurer which has a taxable year other than a calendar year.[199] Finally, the Act specifies the taxable year in which the fresh start adjustment shall be taken into account in determining an insurance company's earnings and profits.[200]

J. Technical Corrections — Miscellaneous

The Act makes a number of additional miscellaneous technical corrections to the 1984 Act's provisions with respect to the taxation of life insurance companies. These changes are detailed below.

(1) The definition of excess interest in Code §808(d)(1)(B) is amended to provide that excess interest with respect to a contract refers only to the amount of interest in excess of the prevailing state assumed rate for such contract.[201]

(2) The Act specifies the manner in which a foreign life insurance company conducting business in the United States should compute its life insurance company taxable income if there is an increase under Code §813 in the company's income effectively connected with the conduct of an insurance business within the United States. The Act provides that any such increase shall be included in gross investment income and added to life insurance gross income before computing the amount of the small life insurance company deduction and the special life insurance company deduction.[202]

(3) The Act restores to the Code a provision of prior law (former Code §819(b)) which sets out rules applicable to distributions from Policyholders Surplus Accounts of foreign life insurance companies doing business in the United States.[203]

(4) The Act clarifies that an "indirect distribution" from a Policyholders Surplus Account does "not include any bona fide loan with arm's-length terms and conditions."[204] The committee reports provide the following commentary:

> [A]n indirect distribution will be treated as occurring whenever policyholders surplus account funds are used to benefit the shareholders indirectly. For example, this may occur by using such funds to purchase stock of a parent or an affiliated company or by using such funds to make loans within an affiliated group for less than adequate consideration. Whether or not a loan is made with arm's-length terms and conditions may be determined by reference to §482 (relating to the allocation of income and deductions among taxpayers) and the regulations thereunder.[205]

Absent arm's-length terms and conditions, the amount which will be treated as an indirect distribution from the Policyholders Surplus Account is limited to the forgone loan made before March 1, 1986, unless the loan is renegotiated, extended, renewed, or revised after February 28, 1986.[206]

(5) The Act restores a provision of prior law which excludes deficiency reserves from the definition of life insurance reserves and total reserves for purposes of the qualification ratio of §816 and for purposes of the computation of surplus held by a foreign life insurance company doing business in the United States under Code §813(a)(4)(B).[207]

(6) The 1984 Act contained a relief provision applicable to corporations which made underpayments of estimat-

[194] Senate Report at 966; House Report at 947.
[195] Code §808(f)(6)-(8).
[196] Act §1822(a).
[197] Act §1822(b).
[198] Act §1822(f).
[199] Act §1822(d).
[200] Act §1822(e).
[201] Act §1821(b).
[202] Act §1821(j).
[203] Act §1821(k)(1).
[204] Act §1821(k)(2); Code §815(a)(2).
[205] Senate Report at 974; House Report at 955.
[206] Act §1821(k)(3).
[207] Act §1821(1); Code §816(h).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ed tax because of the insurance company subtitle of the 1984 TRA.[208] The 1986 Act contains a relief provision of general applicability and the insurance subtitle relief provision of the 1984 Act is therefore repealed.[209] In addition, the Act provides that no interest shall be payable for any period before July 19, 1984, on any underpayment of tax imposed by the Code to the extent such underpayment was attributable to the insurance company subtitle of the 1984 Act.[210]

(7) The Act extends the definition of a pension plan contract set out in Code §818(a)(6) to include an eligible state deferred compensation plan within the meaning of Code §457(b).[211]

(8) TEFRA enacted a "grandfather" provision with respect to the treatment of modified coinsurance contracts for taxable years prior to 1982. Under the grandfather provision, except in the case of fraud, (1) any determination as to whether a contract met the requirements of former Code §820 was to be made solely by reference to the terms of the contract, and (2) the treatment of such a contract was to be determined under the Treasury regulations in effect on December 31, 1981. In 1986, the Service issued certain audit "guidelines" with respect to the treatment of modified coinsurance contracts for taxable years prior to January 1, 1982. The guidelines concerned (1) the date on which modified coinsurance contracts became effective, and (2) the rate at which investment income was transferred under the contracts. In response to the guidelines, the Act contains a clarification of the TEFRA grandfather.[212] The Conference Report explains this "great grandfather" as follows:

> The provision clarifies the intent of Congress that, for taxable years prior to January 1, 1982, the IRS should give full and complete effect to the terms of a modified coinsurance contract. Accordingly, under the provision, the IRS is to respect the manner in which the terms of a modified coinsurance contract have been reflected on the tax return. In particular, the provision requires the IRS to recognize the investment income rate terms and the effective date terms stated in the contract.[213]

V. Policyholder Provisions

A. *Life Insurance Contracts*

1. *Withdrawals*

As enacted in the 1984 TRA, Code §7702, which sets forth the definition of a life insurance contract for federal tax purposes, contained two provisions with respect to changes in the terms of a contract. Code §77O2(f)(2)(A) provided that, in the event of a change in the future benefits (or in any other terms) under the contract which had not been reflected in previous computations under Code §7702, there were to "be proper adjustments in future determinations" under the section. The adjustments were to be made pursuant to regulations. In addition, pursuant to Code §7702(f)(7)(5), any change in the terms of a contract which resulted in the reduction of the future benefits under the contract was to be treated as an exchange. The effect of this rule, according to the 1984 TRA committee reports, was to bring such a change within the ambit of Code §1035. Code §1035 generally provides that gain or loss is not to be recognized on the exchange of one life insurance contract for another, but also provides that, if cash or other property is distributed in connection with an otherwise tax-free exchange of contracts, gain is to be recognized to the extent of the cash or other property distributed, as specified in Code §1031.[214]

The scope of the deemed exchange rule of Code §7702(f)(7)(B) was unclear. The 1984 TRA committee reports explained that the genesis of the rule lay in the Treasury's desire to provide for "gain out first" taxation of amounts distributed from a life insurance contract because of a reduction in the guideline premium limitation due to a change in a universal life insurance contract from an "option 2" death benefit pattern (a death benefit equal to the cash surrender value at death plus a level amount of pure insurance protection) to an "option 1" pattern (a level face amount). It was uncertain however, whether Treasury would limit the scope of the rule in this manner, or whether it would adopt regulations taking a more expansive reading altering the traditional recovery of basis first rules of Code §72(e). In particular, concern arose that, if a partial withdrawal was made from a universal life policy, or if a paid-up addition under a participating policy was surrendered, the cash distributed might be taxable.

In response to this uncertainty, the 1986 TRA made several significant changes in Code §7702(f)(7). First, the Act amended Code §7702(f)(7)(A) to delete the express authority of the Treasury to issue regulations governing adjustments. Second, the Act amended Code §7702(f)(7)(B) to delete the deemed exchange rule and to substitute specific rules — tied to the Code §7702 definitional test applicable to the contract — for determining the extent to which a reduction in benefits will result in income being recognized by the policyholder. The revised rules provide generally that, if a change in benefits within the scope of Code §7702(f)(7)(A) reduces benefits, and a cash distribution is made to the policyholder "as a result of such change," the portion of such distribution which does not exceed the applicable "recapture ceiling" is includible in income to the extent of the income in the contracts as measured under the rules applicable to annuity contracts.[215] This rule applies only to changes occurring within 15 years of the issue date of the contract. Thereafter, the historic rules applicable to life insurance contracts under Code §72(e), *i.e.*, recovery of investment first, apply.

Section 7702(f)(7)(B) contains two different "recapture ceilings." The first, defined in Code §7702(f)(7)(C),

[208] 1984 TRA §218.
[209] Act §§1824, 1879(a).
[210] Act §1829.
[211] Act §1821(n).
[212] Act §1830.
[213] Conference Report, p. II-848.
[214] S. Rep. 98-169, 98th Cong., 2d Sess. 578 (1984); H.R. Rep. No. 432, 98th Cong., 2d Sess. 1448 (1984).
[215] Specifically, §72 (other than subsection (e)(5) thereof) applies to the cash distribution to the extent it does not exceed the applicable recapture ceiling.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

applies where the change in benefits occurs during the first five years after the contract is issued. The second recapture ceiling, defined in Code §7702(f)(7)(D), applies where the change occurs after the first five years and before the sixteenth year after issue.

The recapture ceiling applicable to changes during the first five contract years depends on which of the two definitional tests of Code §7702 the contract is meeting. If a contract is qualifying as a life insurance contract under the cash value accumulation test of Code §7702(a)(1), the recapture ceiling equals the excess of the contract's cash surrender value immediately before the benefit reduction over the "net single premium" for the contract immediately after the reduction. If a contract is qualifying under the guideline premium and cash value corridor tests of Code §7702(a)(2), the recapture ceiling is the greater of (1) the excess of the sum of the premiums paid under the contract immediately before the benefit reduction over the guideline premium limitation for the contract immediately after the reduction, and (2) the excess of the cash surrender value immediately before the reduction over the cash value corridor limitation of Code §7702(d) immediately after the reduction. The Senate Report states that the guideline premium limitation after the benefit reduction shall be determined by using an "attained-age-decrement" method. The committee reports explain this method as follows:

> Under this method, when benefits under the contract are reduced, the guideline level and single premium limitations are each adjusted and redetermined by subtracting from the original guideline premium limitation a "negative guideline premium limitation" which is determined as of the date of the reduction in benefits and at the attained age of the insured on such date. The negative guideline premium limitation is the guideline premium limitation for an insurance contract that, when combined with the original insurance contract after the reduction in benefits, produces an insurance contract with the same benefit as the original contract before such reduction.[216]

The recapture ceiling applicable to changes during years six through 15 is the same irrespective of whether the contract is qualifying under the cash value accumulation test or the guideline premium and cash value corridor tests. During these years, the recapture ceiling equals the excess of the contract's cash surrender value immediately before the benefit reduction over the cash value corridor limitation of Code §7702(d) immediately after the reduction.[217]

The Act also contains a special rule providing that, in certain circumstances, cash distributions from contracts which are made in "anticipation of benefit reductions" will be treated as being made as a result of the benefit reduction and will therefore be subject to the above rules. Specifically, Code §7702(f)(7)(E) provides that such rules shall apply, under Treasury regulations, "to any distribution made in anticipation of a reduction in benefits under the contract." In addition, in all circumstances, any distribution which is made within two years before a reduction in benefits under the contract and which reduces the cash surrender value of the contract will be treated as made "in anticipation of such reduction" and thus subject to such rules.[218]

The foregoing changes apply only to life insurance contracts to which Code §7702 is applies, *i.e.*, generally, contracts issued after December 31, 1984. These changes, however, are effective retroactively to the effective date of Code §7702.

2. Policy Loans

a. Consumer Interest

The Act phases out over a four-year period the deduction for consumer interest by individuals. Specifically, in the case of a taxpayer other than a corporation, no deduction will be allowable after the phase out is complete for "personal interest." Personal interest means any interest other than (1) interest on indebtedness incurred or continued in connection with the conduct of a trade or business (other than as an employee); (2) interest on indebtedness incurred or continued to purchase or carry property held for investment, *i.e.*, investment interest which is subject to separate limitations; (3) interest taken into account in connection with the limitations on losses from passive activities under Code §469; (4) qualified residence interest; and (5) interest on certain estate tax payments.[219] In 1987, 35% of the otherwise allowable interest deduction is disallowed, 60% in 1988, 80% in 1989, and 90% in 1990. Thereafter, no personal interest deduction is allowed.

b. Revised Code Section 264 Limit

In addition to the general limitations on the deduction of personal interest described above, the Act imposed a revised limit on the deductibility of interest on business life insurance policy loans.[220] Specifically, the Act amended Code §264(a) to disallow the deduction of interest on "indebtedness with respect to" any life insurance policy which a taxpayer owns and which insures an officer or employee of, or a person with a financial interest in, any trade or business carried on by the taxpayer, but only to the extent the indebtedness with respect to a particular insured exceeds $50,000.[221] The Conference Report explains that the $50,000 limit is applied on a "per insured" and not a "per business" basis. Thus, the Report states that:

> if an employee of a business of the taxpayer is also an officer in two other businesses of the taxpayer, the $50,000 of permitted borrowings by the taxpayer with respect to life insurance covering the person is determined by aggregating all policies covering his life with respect to which the taxpayer has borrowed.[222]

The Conference Report also contains the following statement:

> Under the conference agreement, the fact that the proceeds of a loan under a life insurance contract are used in a trade or business does not affect the deduct-

[216] Senate Report at 989; House Report at 967.
[217] Code §7702(f)(7)(D).
[218] Code §7702(f)(7)(E).
[219] Act §511(b); Code §163(h).
[220] Act §1003.
[221] Code §264(a)(4).
[222] Conference Report, p. II-341.

> ibility of interest paid on the loan. Therefore, for example, if a sole proprietor borrows under a life insurance policy on the sole proprietor's life, the interest paid on the loan (to the extent the loan exceeds $50,000) is not deductible even though the proceeds of the loan are used in the sole proprietor's trade or business.[223]

While the Conference Report thus seems to provide that the purpose of a policy loan does not alter the limitations imposed by Code §264(a)(4), it does not directly address whether pledging the policy as collateral or other borrowing by the owner could result in a disallowance of an interest deduction under this provision. This question of "tracing" was discussed during the floor-debate on the Act, but there appears to be disagreement between the House and the Senate.[224]

The amendment is effective with respect to contracts purchased after June 20, 1986.[225] There were several discussions of this effective date during and after the floor consideration of the Act.[226] There appears to have been agreement in these discussions that, if an application had been made on or before June 20, 1986, the contract is considered to have been purchased before the effective date of the amendment. There was disagreement between the House and the Senate, however, as to whether certain changes, or exchanges, after June 20, 1986, would be considered to result in the purchase of a new contract subject to the limits of Code §264(a)(4). As a result, there is continuing uncertainty about the consequences under this rule of changes in, and exchanges of, contracts purchased on or before June 20, 1986.

c. Single Premium Contracts

Under Code §264(a)(2), no deduction is allowable for interest on indebtedness incurred "to purchase or carry" a single premium life insurance, endowment, or annuity contract. A single premium contract is a contract where "substantially all" the premiums for the contract are paid within four years, or where an amount is deposited with the insurance company for payment of a "substantial number" of future premiums for the contract.[227] Although H.R. 3838 as reported from the Ways and Means Committee did not amend these rules for single premium contracts, the House Report did discuss the Committee's view of the scope of the rules. In particular, the Report observed that "indebtedness secured by a single premium life insurance contract is generally subject to the rule of §264(a)(2). Section 264(a)(2) also applies to all contracts other than those where the nonpayment of premiums would cause the policy to lapse."[228] The House Report also stated that it had "come to the Committee's attention that some practitioners may characterize a universal life insurance policy as a policy that provides for annual premiums due for purposes of the four out of seven rule" of Code §264(c)(1).[229] Some life insurance companies expressed concern that this language implied that universal life insurance contracts should be viewed as single premium life insurance contracts for purposes of Code §264(a)(2). In response to this concern, the Conference Report "restates the present-law rule" of Code §264 with respect to single premium contracts and, in so doing, observes that

> Generally, §264(a)(2) also applies to contracts other than those where the nonpayment of premiums would cause the policy to lapse, but no inference is intended that universal life insurance policies are always treated as single premium contracts.[230]

3. Installment Payments of Death Benefits

Amounts paid under a life insurance contract by reason of the death of the insured generally are excludible from gross income. Where the insurer agrees to hold the death proceeds on deposit and to make payments over a period of time, a prorated amount of each payment is treated as a payment of the death benefit excludible from gross income and a portion is includible in gross income.[231] Under an exception to the latter rule, however, the first $1,000 in excess of the amount treated as a payment of the death benefit received by a surviving spouse is excludible from gross income each year. The amount treated as held as by the insurer is the amount that equals the value of the agreement to make payments at a later date, or dates, determined as of the date of the insured's death and discounted on the basis of the interest rate and mortality tables used by the insurer in calculating payments under the agreement.

The Act makes two changes in the treatment of death benefits paid under such installment agreements. First, the Act repeals the annual exclusion from gross income for the first $1,000 in excess of the amount payable as death benefits to a surviving spouse.[232] Second, the Act requires that the value of the amount held by the insurer be determined on the basis of mortality tables to be prescribed in regulations, rather than the tables actually used by the insurer.[233] The Senate Report explains that it is expected that the mortality tables prescribed in the regulations will be gender-neutral.[234] These changes apply to amounts received with respect to deaths occurring after the date of enactment of the Act.[235]

4. Definition of Life Insurance — Technical Corrections

The Act makes several amendments to the definition of a life insurance contract set forth in Code §7702. First, the

[223] *Id.*

[224] *Compare* the colloquies between Senators Dole and Packwood on September 21, 1986 (Cong. Rec. S13957) and October 17, 1986 (Cong. Rec. S17055) *with* the statement of Chairman Rostenkowski on October 2, 1986 (Cong. Rec. E3391).

[225] Act §1003(c).

[226] *See* Cong. Rec. S8290-91 (June 24, 1986) (Statement of Senator Dole); Cong. Rec. H8361 (Sept. 25, 1986) (Statement of Chairman Rostenkowski); Cong. Rec. S13957 (Sept. 27, 1986) (Statements of Senators Dole and Packwood); Cong. Rec. E3391 (Oct. 2, 1986) (Statement of Chairman Rostenkowski); Cong. Rec. S17055 (Oct. 17, 1986) (Statements of Senators Dole and Packwood).

[227] Code §264(b).

[228] House Report at 660.

[229] *Id.*

[230] Conference Report, p. II-341.

[231] Code §101(d).

[232] Act §1001(a).

[233] Act §1001(b).

[234] Senate Report at 488.

[235] Act §1001(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

second computational rule under Code §7702(e) is clarified to provide that the maturity date, including the date on which any endowment benefit is payable, shall be deemed to be no earlier than age 95 and no later than age 100.[236] As enacted in 1984, this rule could have been viewed as actually requiring the contract to mature between those dates, rather than simply assuming such a maturity date for purposes of determining compliance with the statutory tests. In addition, a computational rule is added which states that the death benefits shall be deemed to be provided until the maturity date determined under the second computational rule.[237] The committee reports explain that:

> This rule combined with the second computational rule will generally prevent contracts endowing at face value before age 95 from qualifying as life insurance. However, it will allow an endowment benefit at ages before 95 for amounts less than face value.[238]

Also, the Act clarifies that the computational rules do not apply in determining whether a contract satisfies the cash value corridor test of Code §7702(d).[239]

The Act also adopts a special rule allowing contracts which were purchased to cover payment of burial expenses, or which were purchased in connection with prearranged funeral expenses, to take into account limited increases in the amount of the death benefit in determining compliance with the cash value accumulation test.[240] The exception is limited to contracts with an initial death benefit of $5,000 or less and a maximum death benefit of $25,000 or less. In addition, the initial death benefit is to be determined by aggregating all the contracts issued to the same contract owner.

The Act also clarifies the rule in Code §7702(g) for measuring the income on a life insurance policy which fails to qualify as a life insurance contract for federal tax purposes.[241] Specifically, the amendment provides that the income in the contract is computed without reduction by the amount of policyholder dividends paid under the contract during the taxable year. The committee reports explain that this change was necessary to prevent overstating the income in the policy.[242]

As a result of the amendments made in Code §7702(f)(7), described previously, the Act amends the defintion of "premiums paid" in Code §7702(f)(1). The amendment provides that for purposes of Code §7702, the premiums paid under a "life insurance contract shall be reduced by amounts included in the policyholder's income under Code §7702(f)(7) because of a reduction in benefits under the contract.

Finally, the Act amends two transition rules under the 1984 Act with respect to the definition of a life insurance contract. The Act provides that any life insurance policy issued during 1984 which meets the requirements of Code §7702 will be treated as meeting the requirements of Code §101(f) which were applicable in 1984.[243] In addition, the Act clarifies a transition rule provided for certain increasing death benefit policies.[244]

B. Group-Term Life Insurance-Technical Corrections

Act §1827 contains a number of technical clarifications to the 1984 TRA amendments[245] to Code §§79 and 83(e).

1. Determination of Cost for Discriminatory Plans

Code §79(d)(1)(B) was amended, by Act §1827(a), to provide that, in the case of a discriminatory group-term life insurance plan, the cost of group-term life insurance on the life of any key employee shall be the *greater* of the actual cost of the insurance or the amount specified in the uniform premiums table (the "Table I" rates in Regs. §1.79-3(d)(2)). Prior law required key employees to include only the actual cost of the insurance. The Joint Committee Blue Book accompanying the 1984 TRA indicated that such a technical correction was necessary to reflect congressional intent. This amendment is effective for taxable years ending after the date of enactment of the 1986 Act.

2. Definition of Key Employee

Act §1827(c) amends the definition of "key employee" for group-term life insurance purposes (Code §79(d)(6)) to include any retired employee who was a key employee at the time of retirement or separation from service. An employee is key employee at separation from service if the employee was a key employee for the year in which the separation occurs or for any of the four preceding years (see Code §416(i)(1)).

3. Separate Treatment of Former Employees

Act §1827(d) amends Code §79(d), relating to the nondiscrimination requirements applicable to the group-term life insurance provisions, by adding paragraph (8). This paragraph clarifies that, to the extent provided in regulations, the nondiscrimination rules are to be applied separately with respect to former employees and active employees. This statutory provision is consistent with the Blue Book explanation accompanying the 1984 TRA which indicated that separate treatment of retired and active employees would be appropriate because employers often provide lower group-term benefits to retirees.

4. Coordination with Code Section 83

Act §1827(e) makes a clerical correction to Code §83(e)(5), which coordinates that section with Code §79. This correction provides that §83 shall not apply to "group-term life insurance to which §79 applies." Prior law excepted only the cost of such group-term life insurance. Basically, this correction attempts to clarify that, if §79 group-term life insurance is involved, then §79, rather than §83, controls.

5. Clarification of Effective Date

Act §1827(b) provides several clarifications and an amendment to 1984 TRA §223(d)(2), the effective date

[236] Act §1825(a)(1)(A); Code §7702(e)(1)(B).
[237] Act §1825(a)(1); Code §7702(e)(1)(C).
[238] Senate Report at 987; House Report at 965.
[239] Act §1825(a)(3); Code §7702(e)(1).
[240] Act §1825(a)(4); Code §7702(e)(2)(C).
[241] Act §1825(c).
[242] Senate Report at 990; House Report at 969.
[243] Act §1825(d).
[244] Act §1825(e).
[245] 1984 Act §223.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

provision relating to the inclusion of former employees in the case of existing group-term insurance plans. Section 223(d)(2)(C) of the 1984 TRA, relating to benefits provided to certain individuals who retired before January 1, 1987 not being taken into account for purposes of determining whether a plan is discriminatory, was amended to permit such retired individuals to be disregarded at the employer's election.[246]

The several clarifications relate to what qualifies as a comparable successor plan and what individuals were grandfathered under 1984 TRA §223(d)(2). A comparable successor plan includes, with respect to a grandfathered individual, any plan that does not provide increased benefits. If, however, the grandfathered individual's benefits are increased, the individual loses his grandfather protection.[247] It is clarified that individuals who retired before January 2, 1984, (whether or not they had attained age 55 as of such date) are grandfathered. Moreover, it is made clear that the grandfather provisions apply only to individuals who reached age 55 before January 2, 1984 (and not to any employer group-term life insurance plan in existence on January 1, 1984) and who were employed by such employer, or a predecessor employer, at any time during 1983.[248]

C. *Nonqualified Annuity Contracts*

In TEFRA and again in the 1984 TRA, Congress made a substantial number of revisions to the tax treatment of nonqualified deferred annuity contracts to restricting the use of annuities as retirement savings, as opposed to short-term investment vehicles. The 1986 Act expands on this general theme and, in addition, directly addresses the use of nonqualified annuity contracts in deferred compensation arrangements. Congress adopted these changes in part out of a concern that the pre-1986 Code provided an incentive for employees to use nonqualified annuity contracts in deferred compensation arrangements in lieu of providing such benefits under qualified pension plans, which are subject to greater restrictions including nondiscrimination rules and limits on contributions.

1. Nonindividual Owners

Under the pre-1986 Code, an annuity policyholder is not taxed currently on the interest credited to his or her annuity contract (the "inside buildup") until such policyholder receives these amounts either directly or constructively. Code §72(e) provides that amounts received under an annuity contract before the "annuity starting date" are considered withdrawals of income credited to the contract to the extent of such investment income (a "LIFO" rule). In the case of amounts received after the "annuity starting date," the policyholder is taxed at ordinary income rates on the interest income under an "exclusion ratio."

Under the 1986 Code, the inside buildup on individually owned annuity contracts continues to not be taxed until such amounts are received, either directly or constructively. The 1986 Code, however, would subject to current taxation the inside buildup on non-individually owned contracts.

Act §1135(a) adds Code §72(u) which provides that, if an annuity contract is held by a corporation, trust, or any person who is not a "natural person," such contract will, for all federal income tax purposes not be treated as an annuity contract.[249] If, however, the contract's nominal owner is not a natural person but the beneficial owner is a natural person, the contract will be treated as held by a natural person.[250] Because of the general concern over the use of nonqualified annuities in deferred compensation arrangements, the committee reports note that this exception will not be available if an employer is the nominal owner and the beneficial owner is an employee.[251]

If the contract is not an annuity contract under Code §72(u), the income on the contract for any taxable year of the policyholder will be treated as ordinary income received or accrued by the policyholder during that year. For this purpose, Code §72(u)(2) provides that the income on the contract is the amount by which (1) the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed under the contract for all years exceeds (2) the amount of premiums paid, less any policyholder dividends or the aggregate amounts received under the contract that have not been included in income. To prevent tax avoidance, the Service is given the authority to substitute the contract's "fair market value" for its net surrender value in the foregoing computation.

Code §72(u)(3) provides five specific exceptions to the tax on the inside build-up on contracts not held by natural persons. The provision does not apply to (1) annuity contracts acquired by a decedent's estate due to his or her death; (2) annuity contracts held (a) by a qualified pension, profit-sharing, or annuity plan, (b) under a tax-sheltered annuity, or (c) under an individual retirement plan; (3) annuity contracts used to fund structured settlement agreements; [252] (4) annuity contracts purchased by an employer upon termination of a pension plan and held by such employer until such time as the employee separates from service with that employer; and (5) immediate annuities. Code §72(u)(4) defines immediate annuity as an annuity contract purchased with a single premium or annuity consideration, the annuity starting date [253] of which commences no later than one year from the date of the purchase of the contract.

Code §72(u) is effective as to contributions for annuity contracts after February 28, 1986.[254]

---

[246] Act §1827(b)(2).
[247] Act §1827(b)(3).
[248] Act §1827(b)(2).

[249] The statutory language in Code §72(u)(1)(A) provides that such a contract will not be treated as an annuity contract "for purposes of this subtitle." Thus, the contract apparently will not be treated as an annuity for company tax purposes (such as for qualification purposes under Code §816 or for diversification purposes under Code §817(h)), as well as for policyholder purposes under Code §72.
[250] House Report at 704; Senate Report at 567.
[251] *Id.*
[252] The structured settlement exception applies to qualified funding assets purchased by structured settlement companies under Code §130 and to contracts which meet the definition of qualified funding assets under Code §130(d) but are purchased and held directly by property-casualty companies to fund periodic payments for damages.
[253] Annuity starting date is defined in Code §72(c)(4) as "the first day of the first period for which an amount is received as an annuity under the contract."
[254] Act §1135(b).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

2. Penalty Tax

In TEFRA and in the 1984 TRA, Congress amended Code §72 to provide for a penalty tax on certain "premature" distributions (*e.g.*, those prior to age 59½) from annuity contracts. The tax is equal to 5% of the amount includible in income. This penalty did not apply, however, to a distribution that is (1) made after the policyholder reaches age 59½; (2) made to a beneficiary on or after the death of the annuitant; (3) attributable to the policyholder becoming disabled; (4) one of a series of substantially equal periodic payments for life or at least five years (the 60-month rule); (5) from a qualified pension plan; or (6) allocable to an investment before August 14, 1982.

In Act §1123(b), Congress revised the penalty tax for certain "premature" distributions from annuity contracts as part of the overall effort to provide substantially uniform treatment for early withdrawals from all retirement products, including both qualified contracts (including IRAs) and nonqualified contracts.

Act §1123(b) amends Code §72(q) to increase the penalty tax from 5% to 10% of the amount includible in income and to revise the exceptions from the penalty tax in Code §72(q)(2), including the elimination of the pre-1986 TRA law exception for distributions made over a period of at least 60 months. As revised, Code §72(q)(2) provides that the 10% penalty tax does not apply to (1) distributions made on or after the policyholder attains age 59½; (2) in the case of distributions made after April 22, 1987, distributions made on or after the death of the holder of the contract (or where the holder is not an individual, the death of the primary annuitant);[255] (3) distributions attributable to the policyholder becoming disabled; (4) substantially equal periodic payments over the life (or life expectancy) of the taxpayer or the joint life (or joint life expectancy) of the taxpayer and his or her beneficiary; (5) distributions from a qualified pension plan; (6) distributions attributable to contributions before August 14, 1982; (7) distributions from a qualified funding asset under a structured settlement agreement;[256] (8) distributions under an immediate annuity as defined in post-1986 TRA Code §72(u)(4) discussed *infra*; and (9) distributions from an annuity purchased by an employer upon termination of a qualified plan held by the employer until the employee separates from service with the employer.

If distributions to an individual are not subject to the tax because of application of the substantially equal payment exception described above, the tax will nevertheless be imposed if the individual changes the distribution method prior to age 59½ to a method which does not qualify for the exception. The additional tax will be imposed in the first taxable year in which the modification is made and will be equal to the tax that would have been imposed had the exception not applied. Further, this "recapture" tax will apply if an individual does not receive payments under a method that qualifies for the exception for at least five years, even if the method of distribution is modified after the individual attains age 59½.[257]

In general, the revised penalty tax and the revised exceptions thereto are effective for distributions after December 31, 1986.[258]

Act §1123(e) provides a limited exception for distributions from contracts, if as of March 1, 1986, the individual was receiving benefits under the contract pursuant to a written election designating a specific schedule of benefit payments. According to the committee reports:

> this exception, will be available if (1) the annuity contract provides for only one form of distribution or (2) the contract provides that, in the absence of an election to the contrary, an individual will be paid benefits according to the automatic form of payment specified in the contract and the individual is, in fact, receiving benefits in that form. Further, the committee intends that, if the exception applies to an individual, the rules of present law apply to the amounts received. Therefore, if benefits paid would be subject to the 5% additional income tax under present law, that tax will apply to the benefits paid under the exception.[259]

3. Tax on Annuitized Payments

Under the pre-1986 Code §72, in the case of amounts received after the annuity starting date, the annuity policyholder is subject to tax on the interest income under an "exclusion ratio," whereby each payment is treated, in part as a return of the individual's contributions and, in part, as gross income.[260] This exclusion ratio is used over the life of the contract. Thus, if an individual died prior to the expiration of his or her anticipated life expectancy, no deduction was provided for any unrecovered basis. An individual whose actual life was longer than anticipated, however, effectively was able to exclude from income an amount in excess of his or her basis in the contract.

Act §1122(c)(2) amended Code §72(b) to limit the total amount that an individual may exclude from income to the individual's basis in the contract. If an individual outlives his or her life expectancy and hence recovers his or her entire basis in the contract, each subsequent payment would be fully taxable as income. On the other hand, if the individual dies early (*i.e.*, prior to recovering the entire basis), he or she would be allowed a deduction for the amount of the unrecovered basis. This provision applies to individuals whose annuity starting date is after December 31, 1986.

---

[255] The pre-1986 TRA law exception for distributions made on or after the death of the annuitant is available for distributions prior to April 22, 1987, but not thereafter.

[256] Act §1826(d). This exception is identical to the Code §72(u) exception discussed above.

[257] In all cases, the additional tax will not be imposed on amounts distributed after attainment of age 59½.

[258] As noted earlier, the penalty tax exception for distributions made on the death of the *holder* is effective as of April 22, 1987 (*i.e.*, six months after date of enactment).

[259] House Report at 705; Senate Report at 569. Although the statutory language provides that the exception is available for "employees" who separate from service and "employees" in pay status, the same statutory language was a part of the original House and Senate bills. Both committee reports accompanying such bills also stated that the exception applies to nonqualified annuity contracts.

[260] Pre-1986 Code §72(b).

4. Other Annuity Provisions [261]

a. Transfers for Inadequate Consideration

As noted earlier, under Code §72(e), amounts received under an annuity contract before the annuity starting date are treated as coming first from the income credited to the contract to the extent of such income (a "LIFO" rule) and then from the investment in the contract. Also, Code §72(c)(4) provides that any loan against the cash value of an annuity contract, or an assignment or pledge of such a contract, is to be treated as an amount "not received as an annuity" (and thus subject to the LIFO rule governing withdrawals).

Under Act §1826(b)(3), the Code §72(e) LIFO partial distribution rules are expanded to provide that the transfer of an annuity contract without adequate consideration (*e.g.*, by gift) is treated as a surrender by the transferor. Thus, the amount includible in the income of the transferor is equal to the excess of the cash surrender value of the contract at the time of the surrender over the investment in the contract at that time. Correspondingly, the basis in the contract in the hands of the transferee is increased by the amount includible in the income of the transferor.[262]

The revised gift rule is effective for contracts issued after April 22, 1987, does not apply to any transfer to which Code §1041(a) applies (*i.e.*, to transfers of property between spouses or incident to divorce).

b. Mandatory Distribution Rules

In 1984, Congress added Code §72(s) which provides that, for any annuity contract (including qualified contracts) to be treated as such under the Code, it must contain language specifying certain methods of distribution in the event of the contract holder's death. Under this rule, the contract must provide that, if the contract holder dies before the annuity starting date, the entire interest will be distributed within five years after the date of death of the contract holder, or will be annuitized within one year after the date of death over a period equal to the life of the designated beneficiary (or over a period not exceeding the life expectancy of such beneficiary). In the event that the contract holder dies after the annuity starting date but before the entire interest in the contract has been distributed, the contract must provide that the remaining portion of such interest will be distributed at least as rapidly as the distribution method in effect as of the time of the contract holder's death. The distribution requirements of Code §72(s) do not apply, however, in the case of a spousal beneficiary who, in effect, steps into the shoes of the deceased contract holder.

The 1986 Act §1826 revises the distribution rules in the event of the "holder's" (owner's) death with respect to the application of the provision to qualified contracts, to nonindividual holders, and to joint holders. First, the Act added Code §72(s)(5) which provides that the holder mandatory distribution rule shall not apply to any tax sheltered annuity under §403(b), any individual retirement annuity or any annuity under a qualified plan. The effective date of this technical correction to the 1984 Act relates back to the original effective date of Code §72(s) — contracts issued after January 18, 1985.

Section 72(s)(7) of the 1986 Code provides that, if the holder of the annuity contract is not an individual, the "primary annuitant" is treated as the holder. If the primary annuitant is changed, the situation is treated as if the holder died and thus a Code §72(s) distribution is triggered. For purposes of the Code §72(s) distribution rules, the term "primary annuitant" is defined as "the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Code." [263]

Finally, Act §1826(b)(2) amends Code §72(s) to provide that, if there is more than one holder of an annuity contract (*e.g.*, joint owners) the mandated distribution must be triggered on the death of the first of them.

The nonindividual distribution rule and the joint holder distribution rule are effective for contracts issued after April 22, 1987.

D. Structured Settlements

Code §104(a)(2) excludes from the gross income of an individual the amount of any damages received on account of personal injury or sickness, whether by suit or agreement and whether as a lump sum or as periodic payments. If not taken in a lump sum, the injured party and a defendant, (*e.g.*, a property-casualty company) may agree to provide for periodic payments through a structured settlement agreement. In such cases, the defendant's property-casualty company will fund its liability by directly purchasing an annuity contract or will assign its liability for periodic settlement payments to a third party assignee (which may be an insurance company) who, in turn, funds its obligation by purchasing an annuity contract (a "qualified assignment").

In the case of such a qualified assignment, Code §130 provides that the third party assignee may exclude from gross income amounts received in consideration for its liability assumption to the extent such amounts are invested in a "qualified funding asset." Code §130(d) defines qualified funding asset as any annuity contract issued by an insurance company or any obligations of the United States. Code §130 further provides that the third party assignee's basis in the annuity contract (*i.e.*, its investment in the contract under Code §72) is reduced by the amount of this excluded income.

Under the Code §72 exclusion ratio, the third party assignee must include all annuity receipts in gross income. Such assignee can offset, however, its Code §72 income with a Code §162 deduction for the periodic payments it makes to the injured party. A qualified assignment under Code §130(c) is limited to assignments to make periodic payments on account of personal injury or sickness.

[261] Act §1826 contains a number of technical corrections to the annuity provisions of the 1984 Act. The technical corrections to the penalty tax in Code §72(q) were addressed under the general penalty tax section. The discussion that follows is of those technical corrections not addressed earlier.

[262] 1986 Code §72(e)(4)(C)(iii).

[263] Code §72(s)(6)(B).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Act §1002(a) amends Code §130(c) to provide that qualified assignments under Code §130 will be limited to those assignments requiring the payment of damages on account of a claim for personal injuries that involve physical injury or physical sickness of the claimant. According to the Conference Report, personal injuries that involve physical injury or physical sickness include "damages on account of a claim for wrongful death arising from physical injury or sickness, provided the assignments meet all other applicable requirements." [264] Claims involving defamation of a third party or invasion of privacy, however, do not involve physical injury or physical sickness and thus are ineligible to be treated as a structured settlement agreement under Code §130.[265]

The Conference Report further provides that in the case of multiple claims in physical injury actions:

> [t]he conferees do not intend that allocation of damages is necessary among such multiple claims. Rather, if the action has its origin in a physical injury, then all damages that flow therefrom are included.[266]

This provision is effective for qualified assignments entered into after December 31, 1986.

Under Act §1135(a), annuity contracts used as qualified funding assets under Code §130(d), without regard to whether there is a "qualified assignment," are exempt from the tax on the inside buildup on nonindividually owned annuity contracts. Thus, the inside buildup on a corporate-owned annuity used to fund a structured settlement agreement will not be subject to current taxation if (1) such contract is a qualified funding asset held by a third party assignee under Code §130 or (2) such contract is a qualified funding asset but is purchased and held directly by a property and casualty insurance company. Further, such contracts funding structured settlement agreements are exempt from the Code §72(q) penalty tax for "premature" withdrawals.[267]

[264] Conference Report, p. II-339-340.
[265] *Id.*
[266] 1986 Code §72(u)(3)(C).

E. Exchanges Under §1035

Under Code §1035, no gain or loss is recognized on the exchange of (I) a life insurance contract for another life insurance contract or for an endowment contract or an annuity contract; (2) an endowment insurance contract for another endowment contract with the same or earlier payment date or for an annuity contract; or (3) an annuity contract for another annuity contract. For purposes of this exchange rule, an endowment contract and a life insurance contract are defined under Code §1035(b)(1) to include only contracts issued by an insurance company taxable under subchapter L of the Code.

Act §1828 amends Code §1035(b)(1) to delete the requirement that the life insurance contract or endowment contract be issued by a company taxed under subchapter L of the Code. Thus, under the 1986 TRA, for purposes of Code §1035, an endowment or life insurance contract includes any contract issued by an insurance company, whether or not such company is a taxable entity under the Code.

[267] Act §1826(d).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Chapter 76

REAL ESTATE OVERVIEW

A. L. Suwalsky, Jr., Esq.
Silverstein and Mullens
Washington, D.C.

I. Introduction

The Tax Reform Act of 1986 ("1986 TRA" or the "Act") [1] was signed into law on October 22, 1986, thus establishing the Internal Revenue Code of 1986. This lengthy revenue act, called by some legislators the most significant change to the Code since the enactment of the first income tax law, follows by little more than two years the Tax Reform Act of 1984, [2] a massive and still undigested piece of legislation which might be said to have signaled a declaration of war on real estate tax shelters.[3]

If the Tax Reform Act of 1984 fired the opening salvos at the favored position of real estate investments, the 1986 TRA might be said to have administered the *coup de grace*. It is generally acknowledged that, aside from the corporate tax, real estate was chosen to bear the main burden of tax reform and revenue raising — some $50 billion worth in the case of real estate. Clearly, no other revenue act has had the broad impact on real estate ownership and investment that the 1986 TRA will have.

Since lower marginal rates are being paid for in substantial part by reducing the advantages of real estate ownership, it is ironic that a perusal of H.R. 3838 finds real estate directly mentioned only in Title II, Subtitle F, containing Act §251, limiting the rehabilitation credit, and Act §252, instituting the low-income housing credit. Thus, it is necessary for the real estate tax professional to look carefully at the entire Act.

The foregoing notwithstanding, numerous statutory changes affecting real estate investments, investors, and property owners were brought forward during the debates on the Treasury and President's proposals, the predecessor bills, and finally the 1986 Act. The issues discussed in this chapter, while not all-inclusive, reflect the broad coverage of real estate matters by the 1986 TRA.

Note that master limited partnerships, the "hottest" item in the current inventory of tax shelter vendors, are not dealt with in the Act. Sources within the Treasury have indicated that an agreement was reached with the tax-writing committees that the "association" issue (Code §7701(a)(3)) would not be pursued at this time. No such agreement was reported concerning the administrative characterization of income from master limited partnerships as portfolio income, however.

A summary treatment of the major issues relating to real estate follows; these issues are discussed in greater depth in other chapters of this Portfolio, as noted.

II. Real Estate Issues in 1986 TRA

A. Rate Reduction for Individuals

(Chapter 10, Part II, this Portfolio; Act §101, amending Code §1; effective 12/31/86, with a "blended rate" applicable for the transition year of 1987 (maximum 38.5%); Conf. Rep. p. II-1)

The Act reduces the 15 bracket system of 1986 with marginal rates of from 14% to 50% to a nominal two bracket system in 1988.[4] Even though the true top marginal rate is 33% for a family of four with up to $192,930 taxable income, the maximum overall rate of 28% for families with incomes that exceed this figure is substantially lower than the current rate and cannot help but influence the conduct of real estate investors. Since a deduction is worth less after 1986, the risk of loss is greater.

At the beginning of the Reagan administration (and earlier), the Treasury took 70% of the risk of investments in tax shelters, leaky or otherwise. Now, the bulk of the funds at risk are the taxpayer's own and most investors will seek income rather than deductions. In particular, many taxpayers locked into shelters that produce so-called "passive" losses (discussed at II, C, *infra*) will seek offsetting passive income.

Naturally, the lowering of marginal rates does not signify the end of investments that produce tax losses or that investors will no longer seek to reduce their taxes. Many of those with sources of "passive" income will doubtless seek to match such income against leveraged investments that provide cash flow and produce tax "losses" through depreciation deductions. The emasculation of the "at-risk rule" (discussed at II, D, *infra*) by continuing to allow real estate investors to take advantage of the leverage produced by nonrecourse financing leaves the door at least partially open to the sheltering of income.

[1] H.R. 3838, P.L. 99-514.
[2] Division A of the Deficit Reduction Act of 1984, P.L. 98-369.
[3] *See* 984 T.M., *The Tax Reform Act of 1984*, Chapters 38 and 42 and the references contained therein.
[4] In transition year 1987, five brackets - 11% to 38.5% - will exist.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

B. Elimination of the Capital Gains Differential for Individual Taxpayers

(Chapter 2, Part V, this Portfolio; Act §§301 and 302, repealing Code §1202 and adding Code §1(j), effective for TYBA [5] 12/31/86; Conf. Rep. p. II-105)

Effective for taxable years beginning after December 31, 1986, the 60% capital gains deduction for individuals is repealed and long term capital gains will be taxed as ordinary income. The formerly deductible amount is no longer a tax preference. However, in (transition year) 1987, when the top marginal rate is 38.5%, long term capital gains will be taxed at a maximum rate of 28%.

The relatively high rate of tax on capital gains and the absence of a differential between long term gains and ordinary income is bound to influence real estate investment patterns, particularly in the near future and when combined with other provisions of the 1986 TRA such as installment sale changes. However, the threat of huge budget deficits has led many persons, especially members of Congress, to openly discuss the need to raise more revenue. The Conference Report states (at II-106) that: "The current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase."

Note also that individual taxpayers may still offset only $3,000 of capital losses against other income, but may carry losses forward indefinitely.

C. Limitations on Deductibility of Losses and Credits from Passive Activities

(Chapter 17 (losses) and Chapter 15, Part II (credits), this Portfolio; Act §501, adding Code §469, generally effective for TYBA 12/31/86 with special rule for low-income housing; Conf. Rep. p. II-137)

The 1986 Act's principal weapon against real estate (and other) tax shelters is contained in Act §501, which limits the use of losses and credits from so-called passive activities to offset "positive income" from other sources, such as earned income and portfolio income. The Senate Finance Committee Report [6] contains a lengthy discussion of the deleterious effects of tax shelters and postulates that, in order to maintain the integrity of the tax system and to retain the confidence of the public that the system is essentially fair, positive income of individuals should be subject to tax without offset for losses not arising out of the activity that produced the income.

The Senate Report goes on to say that: ". . . the committee believes that it is appropriate to treat losses of the [passive] activity as not realized by the investor prior to disposition of his interest in the activity." [7] This, then, is the basic rationale which culminated in the passive loss provisions contained in new Code §469 and is likely to guide the interpretation of the law by the Service.

The limitations on the deduction of passive losses apply to individuals, estates, trusts, partnerships, S corporations, and personal service corporations. Closely held corporations may offset passive losses against active business income but not portfolio income. While widely owned C corporations have no such restriction, such deductions could increase the corporation's exposure to the alternative minimum tax.[8]

Under the 1986 Code rules, losses from passive investments can only be used against gains from like activities, and credits are generally usable only against taxes generated by passive activities. An individual or entity subject to the passive loss rules may be deemed to be engaged in two or more separate activities with the result that income or loss may have to be allocated among activities rather than netted out and may be characterized differently depending upon the activity generating it. Whether a taxpayer will be permitted to assert that his proprietorship or partnership is engaged in separate activities when it is to the taxpayer's advantage to do so is open to question. Some practitioners fear that the Service will vigorously resist taxpayers' attempts to create passive income, for instance.

Disallowed ("suspended") losses and credits may be carried forward indefinitely and suspended losses may generally be allowed in full against other income upon the complete taxable disposition of the passive investment; unused credits may not be utilized against taxes arising out of other income, however, and such credits disappear at death. It is unclear whether gain from the disposition of a passive activity can be used to offset passive losses of another activity.

Loss producing activities subject to the new rules are not confined to rental real estate or tax shelters. For an individual to be entitled to take losses as active business losses, he must "materially participate" in the operation of the business. Limited partners, *per se*, are deemed not to materially participate, regardless of their employment in the business. Inactive S corporation shareholders and other like beneficiaries of pass-through entities do not materially participate in the operation of the business of the entity. The material participation determination is a "facts and circumstances" test based on such criteria as the amount of time devoted to the business, physical presence at the place of business, knowledge and experience, management authority, etc.

With the exception described below, rental activities are considered passive in nature whether or not an individual actively participates in the operation of the rental activity. A concession was made to small real estate operators [9] who are allowed to use up to $25,000 of passive losses (or to claim an equivalent amount of credit) arising out of rental real estate activities in which they "actively participate" as an offset against other income. For married couples filing a joint return, this $25,000 of losses phases out completely for adjusted gross incomes of between $100,000 and $150,000.[10]

[5] "TYBA" (taxable years beginning after).

[6] S. Rep. No. 313, 99th Cong., 2d Sess., at 713-46.

[7] *Id.* at 716-17. The Senate Report notes that a 1985 Treasury study revealed that in 1983, out of 260,000 tax returns reporting "total positive income" in excess of $250,000, 32% paid no more than 10% of that income in taxes. For returns reporting "total positive income" in excess of $1 million, 30% paid no more than 10% of that income in taxes. (S. Rep. at 714.)

[8] *See* Chapter 32, this Portfolio.

[9] An example of a person falling under this exception might be an investor who owns a few rental houses or an apartment or two which he manages himself.

[10] For example, only $12,500 would be available to a couple with a gross income of $125,000.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

On death, suspended losses may be utilized on the final return of the decedent to the extent that they exceed the amount of the step-up in basis given the asset at death. When an interest in property with which suspended losses are associated is exchanged or given away, the suspended losses are not triggered [11] but are allowed upon the taxable disposition of the interest.

The passive loss provisions have a substantial interconnection with the installment sales provisions, at-risk rules, low-income housing credit, rehab credit, alternative minimum tax, basis rules, investment interest limitations, related party rules, and other Code provisions.

The disallowance (suspension) of passive losses is phased in over four years (65%, 40%, 20%, 10%, 0% allowable) beginning in 1987 and is retroactive in the sense that investments made before 1987 are not grandfathered.

The application and interpretation of the passive loss rules appears difficult and uncertain at this time, particularly in view of the Congressional mandate to Treasury to promulgate legislative regulations:

> ". . . necessary or appropriate to carry out the provisions of [Code §469], including regulations —
>
> (1) which specify what constitutes an activity, material participation, or active participation, for purposes of this section,
>
> (2) which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income),
>
> (3) requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity,
>
> (4) which provide for the determination of the allocation of interest expense for purposes of this section, and
>
> (5) which deal with changes in marital status and changes between joint returns and separate returns." [12]

The grant of authority given the Treasury could hardly be broader. The Conference Report states that the authority is to be exercised to "protect the underlying purpose of the passive loss provision, *i.e.*, preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities." [13] Some of the more pessimistic tax practitioners have voiced the fear that the Service will use its expansive authority to classify most losses and credits as passive and most income as active, thus preventing offsetting, even within the same type of activity. One example frequently given is the popular master limited partnership which could be deemed to produce portfolio income and passive losses.

It is conceivable that the characterization of income issue could clog the courts with factual disputes.[14] Further, the Act introduces "material participation" and "active participation" standards which seem incapable of precise definition. A major challenge for tax practitioners in the next several years may be to find unassailable ways in which to characterize or recharacterize income as passive.

Because of the broad scope and complexity of the passive loss rules, the reader is referred to the detailed discussions to be found in Chapters 17 (losses) and 15, Part II (credits) of this Portfolio, and to Madden, "The Passive Loss Rules: A New Day for Real Estate," 2 *Tax Mgmt Real Est. J.* 264 (Dec. 1986).

D. Extension of At-Risk Limitations to Real Property

(Chapter 16, this Portfolio; Act §503, amending Code §465, generally applicable to losses incurred after 12/31/86 with respect to property placed in service after 12/31/86 (a special rule applies to pass-through entities); Conf. Rep. p. II-134)

The amount that a taxpayer is deemed to have "at risk" in an activity is one limitation on the deductibility of losses arising from that activity. The amount is computed by aggregating the following: (i) cash contributed; (ii) the adjusted basis of contributed property other than cash; (iii) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has put up collateral not used in the activity; and (iv) his pro rata share of "qualified nonrecourse financing." The amount at risk is increased by income and contributions and decreased by withdrawals and losses. The amount at risk is not the same as the amount of the taxpayer's basis in the activity but either amount can operate as a limit on the deductibility of losses arising out of the activity. Note also the interaction of the at risk rules with the passive loss rules.

The "at-risk" concept is not new in the tax code, having been applied to leveraged investments in personal property since the enactment of the Tax Reform Act of 1976.[15] That this rule was finally made applicable to real estate demonstrates the intensity of the government's war on tax shelters. That a loophole "big enough to drive a truck through" (in the words of one member of Congress) by way of the "qualified nonrecourse financing" exception [16] was inserted reveals the power of the real estate industry and the latent fears of Congress that a serious recession might be engendered as a result of pushing too hard against real estate.

The qualified nonrecourse financing exception includes financing secured by real property for which the owners are not personally liable if the creditor is a governmental entity or someone guaranteed by a governmental entity or "qualified person" (as defined in Code §469(b)(6)(D)). A qualified person includes pension trusts and financial institutions but excludes any person from whom the property was acquired (or a person related to such person), any person related to the taxpayer (unless the terms of the loan are commercially reasonable and comparable with loans made to unrelated persons), or any person (such as a promoter) who receives a fee in connection with the investment in the property.

---

[11] Except to the extent of taxable boot in an exchange.

[12] Code §469(k).

[13] Conf. Rep. at II-147.

[14] It is easy to imagine the courts declaring that such cases are without precedential value since each is "distinguishable on its facts" — shades arise of reasonable compensation, hobby loss and profit motive disputes, giving rise to long judicially originated lists of "factors" or "tests," none of which is in itself determinative.

[15] P.L. 94-455.

[16] Act §503(b), adding Code §465(b)(6).

This exception for qualified nonrecourse financing has been seen as providing numerous traps for the unwary and substantial uncertainty, although the case law and regulations developed with respect to personal property investments would seem to apply. The question of guarantees, indemnities, and stop-loss provisions is a difficult one. A separate but related question concerns basis in the partnership context. Partnership level nonrecourse financing may increase the amount a partner is deemed to have at risk without causing a corresponding increase in the basis of his partnership interest. The rules in this area are many and complex and, in some instances, unestablished. Meaningful anomalies exist, such as that provided by the rule that a lender who is the seller of the property cannot provide "qualified" nonrecourse financing. While the purpose of such a rule is recognized, its scope appears overbroad since it would seem to preclude *bona fide* financial institutions disposing of foreclosed properties from financing the purchase of the properties.

E. Installment Sales

(Chapter 18, Parts I and III, this Portfolio; Act §811, adding Code §453C, generally effective for TYEA [17] 12/31/86 with respect to dispositions after 2/28/86 (numerous exceptions and transition rules); Conf. Rep. p. II-293)

Real property held by a "dealer" for sale to customers, used in a trade or business, or held for the production of rental income, when sold on the installment method for an aggregate selling price of $150,000 or more will generate "applicable installment obligations" subject to a set of new rules, termed collectively the "proportionate disallowance rule." Under these rules, income is imputed to the seller each year under a formula based on his outstanding business debt as if he had pledged a portion of the installment obligations and received cash.[18]

Another important term introduced by the Act is "applicable installment indebtedness" or "AII." The amount of a taxpayer's AII for a taxable year is treated as a payment received immediately before the close of the taxable year on the applicable installment obligations generated in such year and outstanding at the end of such year. AII is computed by dividing the face amount of applicable installment obligations outstanding at the end of the taxable year by a sum equal to the face amount of *all* installment obligations held plus the aggregate adjusted bases of all business assets held by the taxpayer.

The resulting fraction is multiplied by the taxpayer's average (quarterly or annual, as applicable) indebtedness. The amount deemed received currently is determined by subtracting AII attributable to applicable installment obligations received in prior years from current AII. The gain to be recognized currently is computed by applying the seller's gross profit ratio to the deemed payment. An individual does not take into account certain farm property or personal use property (*e.g.*, his home) or indebtedness secured by such excluded property. The Treasury is given broad regulatory authority to disallow the use of the installment method when the effect of the proportionate disallowance rule would be avoided through the use of related parties, pass-through entities, or intermediaries.

If the taxpayer disposes of his entire interest in an activity through an installment sale, suspended losses are allowed each year in proportion to the gain recognized in each year. Suspended losses may be used against the gain required to be recognized currently as a result of the proportionate disallowance rule, recapture, or encumbrances in excess of basis.

In subsequent years, a taxpayer is not required to recognize gain attributable to applicable installment obligations from a prior year to the extent that payments do not exceed the amount of AII attributable to such obligations. Payments received in a year reduce the AII attributable to the obligation and payments in excess of AII are accounted for under ordinary installment sale rules. Thus, there is no double counting. Sellers owning low basis property with substantial debt may be unable to derive any benefit from an installment sale and, in any case, must be careful to demand a downpayment sufficient to pay tax on the gain required to be recognized.

A good bit of the impetus behind the enactment of the proportionate disallowance rule for installment sales apparently originated in a perceived "abuse" by builders of residential housing arising out of the issuance of "builder bonds," a transaction in which a builder pledges the purchase money mortgages received from homebuyers in return for a loan equal to most of his costs and profits from the sale of the underlying property while reporting income on the installment basis as mortgage payments are received. Although the result is the deferral of taxes on money received in hand, such a system quickly recycles housing construction funds and promotes broader home ownership. Dealers in personal property offering revolving credit plans were also thought to be taking undue advantage of installment sales. Like many provisions of the Act, however, a substantial purpose of the amending legislation doubtless was to raise revenue. This may account for the overbroad scope of the provision which has the potential to result in mismatches of cash receipts and tax liability, contrary to generally accepted tax principles.

F. Limitations on the Deduction of Investment Interest

(Chapter 5, this Portfolio; Act §511(a), amending Code §163(d), generally effective for TYBA 12/31/86 with phase-in; Conf. Rep. p. II-153)

The investment interest limitation has been refashioned as part of the characterization of income, expenses, and credits into categories such as personal, consumer, passive, positive, business, investment, and portfolio. The purpose of defining different types of income, expenses, and credits is to maximize taxable income and reduce offsetting deductions and losses, *i.e.*, to produce mismatches between certain types of income, deductions, and credits so that the benefit of deductions, credits, and losses is postponed or even eliminated. The boundaries between categories are shadowy and the Treasury has been given a broad grant of authority under the passive loss rules to recategorize in-

[17] "TYEA" (taxable years ending after).

[18] Debt from sales of personal property by a dealer in same is subject to similar rules but will not be discussed here.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

come and deductions even in a single activity.[19] The interest expense rules of Act §511 are closely tied in with the Act's passive loss provisions and incorporate significant references to those provisions. Accordingly, the investment rules should be studied in conjunction with the passive loss rules when evaluating ongoing or proposed real estate operations.

Following is a brief description of some of the particulars of the investment interest rules. Perhaps the most conspicuous change is the repeal of the $10,000 allowance for investment expense under Code §163(d). Subject to a five year phase-in, the first dollar of investment interest not offset by investment income becomes non-deductible (but unlike consumer interest, it can be carried forward indefinitely). However, the Act expands the definition of investment income to include gain on the disposition of investments.

Generally, investment interest is all interest except consumer interest and qualified residential interest on debt not incurred in connection with an active trade or business. However, as to the individual taxpayer, the allocable share of interest expense from a business in which the taxpayer does not "materially participate" is investment interest. If the business activity is a "passive activity" or a rental real estate operation, however, the interest ceases to be investment interest and is subsumed as an expense of that activity or operation. If a passive activity has portfolio income, interest expense that can be allocated to carrying the portfolio investments will be investment interest. Of course, the income from portfolio investments owned by the passive activity cannot be used to offset other expenses of the passive activity.

There is a significant relationship between the passive loss limitations and the excess investment interest limitations during the four year phase-in period (65%, 40%, 20%, 10%, 0% allowable) starting in 1987. Investment income is reduced by the allowable portion of the passive loss (*e.g.*, 65% of that portion not attributable to rental real estate activity in which the taxpayer actively participated in 1987 (subject to the $25,000 ceiling)), but that is only the starting point for computing the amount disallowed. *See* Code §§163(d)(4)(E) and 163(d)(6) for the formula, and Conference Report at II-156-57 for an example. The greater the amount of passive losses, the more investment interest disallowed, but the result is not linear.

An extremely important and as yet unanswered question has arisen with respect to the use of loan proceeds. The tax treatment of the interest paid with respect to both personal and business loans could be determined by several methods producing varying results, including: (1) *pro rata* allocation among business and/or personal debts; (2) correlating the tax treatment to the source of the borrowed funds; and (3) actual tracing of the use of loan proceeds. No single method proposed seems likely to accomplish such disparate objectives as fairness, ease of administration, maximum production of revenue, and full taxpayer compliance. The question looms especially large and immediate in the real estate context because of the common practice of refinancing appreciated properties and distributing the equity to the owners or partners. Because of the large amounts of revenue involved, this is an issue which should be addressed immediately by the Treasury.

For a further discussion of the rules applicable to investment and consumer interest, *see* Chapter 5 of this Portfolio. *See also* Weiner, "A Few Matters of Interest Under the Tax Reform Act of 1986," 2 *Tax Mgmt. Real Est. J.* 270 (Dec. 1986).

G. Disallowance of Consumer Interest

(Chapter 5, this Portfolio; Act §511(b), adding Code §163(h), generally effective for TYBA 12/31/86; Conf. Rep. p. II-154)

Subject to the four-year phase-in rule (65%, 40%, 20%, 10%, 0% allowable) starting in 1987, no deduction is allowed for consumer or personal interest, *i.e.*, interest which is not business interest, investment interest, or qualified residence interest, *e.g.*, interest on credit card purchases, auto loans, and tax deficiencies. There is no carryforward for disallowed consumer interest.

Deductible qualified residence interest is the mortgage interest on the taxpayer's primary residence plus one other residence (apparently including a boat!) selected by him. For mortgages placed before August 17, 1986, all interest will be deductible to the extent of fair market value of the property. Interest on mortgages placed after August 16, 1986 will be deductible to the extent of the original cost (not the basis) of the residence plus the cost of any home improvements, plus interest on borrowings made for qualified medical or educational purposes with the property pledged as security, the total qualifying indebtedness again being limited to fair market value.

Most laymen are aware of the interplay between the consumer interest limitations and the residential interest limitation so there is substantial room for maneuvering for many taxpayers who refinanced before August 17, 1986, or those who have not refinanced but whose remaining mortgage balance is less than the cost of the property plus improvements. Renters and first time home buyers are not in this advantageous position and it is likely the issue of fairness will be raised in future tax debates.

Numerous unanswered questions have already arisen regarding future taxpayer compliance if a tracing requirement is instituted to preclude the use of interest-deductible home mortgage proceeds for consumer-type purchases or obligations the interest attributable to which would not otherwise be deductible. In contrast, certain taxpayers will wish to claim an interest deduction on amounts in excess of their cost plus improvements ceiling on post-August 16, 1986 loans when the proceeds are invested in an active business.

H. Depreciation Changes - Modified ACRS System

(Chapter 4, this Portfolio; Act §201, amending Code §168 and other sections, generally applicable to property placed in service after 12/31/86 in TYEA 12/31/86 (*see also* Act §203); Conf. Rep. p. II-39)

The latest system of depreciation has been styled the modified ACRS system (accelerated cost recovery system). Lives of 27-1/2 years and 31-1/2 years for property placed

[19] *See* Code §469(k).

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

in service after 1986 have been assigned to residential (including low-income housing) and non-residential real property, respectively. The problem of mixed use office/-residential or hotel/residential property is addressed by requiring at least 80% of gross rents to come from the leasing of dwelling units (excluding hotel or transient accommodations) to qualify the property for the 27-1/2 year schedule. Depreciation is calculated using the straight-line method and the mid-month convention.

No provision has been made for indexing for inflation. There is no ordinary income recapture on the disposition of residential or non-residential property. Capital gain on disposition is treated under the capital gains rules now applicable. Since the underpinnings of the system of capital gains taxation have been retained in the Code, recapture may again be a concern if tax rates are raised.[20]

Taxpayers may elect the Alternative Depreciation System to recover the cost of residential and non-residential real property over 40 years on a straight-line basis. An automatic tax preference will result from the use of 27-1/2 and 31-1/2 year lives for real property in that depreciation in excess of the 40 year straight-line method is a tax preference for purposes of the alternative minimum tax.

Changes have been made in the rules for depreciating leasehold improvements and lease acquisition costs. Buildings erected on leased land are to be depreciated using 27-1/2 or 31-1/2 year lives, and other improvements are to be depreciated over the ACRS recovery period, regardless of the remaining length of the lease. Gain or loss is to be measured upon the expiration of the lease.

I. Mortgage Backed Securities; Real Estate Mortgage Investment Conduits ("REMICs")

(Chapter 42, this Portfolio; Act §§671-675, adding new Code §§860A-860G, 6049(d)(7) and 7701(i), and amending Code §§582(c), 593(d), 856(c), 1272(a), and 7701(a), generally effective for TYBA 12/31/86, except that the provisions for taxable mortgage pools take effect on 1/1/92; Conf. Rep. p. II-222)

Although virtually unknown even to sophisticated laymen who purchase "Ginnie Maes" for their retirement accounts, the secondary mortgage market and the mortgage-backed securities it offers are, respectively, the engine and the fuel for the housing industry in America. The secondary mortgage market recycles lenders' funds, thus making mortgage money available for the purchase of homes over and over again. The Act, in new Code §§860A-860G, brings new order to, and reduces uncertainties in connection with, the issuance of mortgage-backed securities ("MBS") by creation of the "Real Estate Mortgage Investment Conduit" or "REMIC."

There are many advantages inherent in investing in MBS and one significant disadvantage — there is no way to predict with certainty the rate at which the underlying mortgages will be paid off. If mortgages are taken out during a period of abnormally high interest rates, many of them will be paid off and refinanced when interest rates go down. Conversely, mortgages taken out during a period of favorable interest rates tend to be cherished by homeowners and passed along to new buyers if the terms of the instrument permit. The multiple class MBS attempts to resolve this uncertainty by issuing securities with short, intermediate, and long maturities based upon a pool of mortgages with the same maturity, *e.g.,* 30 years. Principal and interest from all mortgages in the pool are used first to pay off the earliest maturing class or "tranche" of "regular interests" when due and then applied to successive classes of interests. The "residual interest" holders take whatever the pool is able to earn in excess of its fixed obligations.

The REMIC was devised as a pass-through entity to assemble mortgages and issue multiple class securities because Treasury determined that taxation at the entity level could not be avoided without specific legislative authorization. Accordingly, Code §7701 was amended to provide for the organization of REMICs. The Act provides a grace period ending December 31, 1991, during which any vehicle can be used for issuing MBS that are multiple class debt obligations. Thereafter, entities issuing any securities other then REMICs are to be characterized as "taxable mortgage pools" and subject to two levels of taxation. For a MBS such as a pass-through MBS, any vehicle can continue to be used.

In form, a REMIC may be any legal entity allowed under state law, *e.g.,* a corporation, partnership, or trust, whose assets consist primarily of a pool of mortgages and that elects REMIC status on a federal partnership tax return for its first taxable year. Despite the flexibility allowed sponsors of a REMIC in choosing its superficial form of entity, the rules for REMICs are tightly drawn. It is a single-purpose, relatively short-lived and self-liquidating entity created by a sponsor that holds mortgages, for example, the Federal National Mortgage Association ("Fannie Mae"). Rather than being an ongoing business which conducts day-to-day operations, the REMIC is basically a pool of similar assets which have been contributed to the REMIC in exchange for certificates representing "interests" in the pool that are ultimately sold through established financial channels.

Holders of regular interests are treated (and taxed) as holding debt instruments regardless of the nominal form in which these interests are issued. Further, regardless of their method of accounting, the holders must recognize income on the accrual basis. The original issue discount rules of Code §1272 are applicable to REMIC securities issued at a discount. The holder of a residual interest in a REMIC is required to recognize his ratable portion of the taxable income or loss of the REMIC for each day during the taxable year he held such interest.

The REMIC itself is a pass-through entity generally not subject to federal taxation, although state tax laws may differ. However, a REMIC is subject to a 100% tax on prohibited transactions, such as receipt of fees in compensation for services and the receipt of income attributable to an asset which is neither a qualified mortgage interest nor a permitted investment.

REMICs have advantages which have caused many to predict that they will quickly become the dominant vehicle

[20] With a reinstitution of the capital gains differential, the recapture amount might be the difference between depreciation under the modified ACRS system and the Alternative Depreciation System.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

for issuing MBS, even before 1992. Some of these advantages include:

1. With certainty of tax treatment, a REMIC can assemble a multi-million dollar pool of similar mortgages and issue in exchange therefor classes of debt instruments with different fixed maturities and interest rates, and a single class of "residual interests" deemed to be equity interests. The holders of the residual interests are entitled to everything left in the pool when the holders of all regular interests have been paid off.

2. Regular and residual interests in REMICs constitute qualifying real estate assets for financial institutions and REITs.

3. Elimination of the over-collateralization required to structure collateralized mortgage obligations as true debt for tax purposes and elimination of the reinvestment risk inherent in accumulating and reinvesting monthly mortgage payments prior to the quarterly date on which investors are paid. Payments from a REMIC can be made monthly.

4. Pass-through MBS containing mortgages originated on or before July 18, 1984 held by a REMIC are not taxed to foreign investors, even in the absence of a suitable treaty provision.

5. Issuers of MBS will be able to structure the transaction as a financing or an asset sale. For example, a grantor trust can be used to issue REMIC securities, thus resulting in the sale of an asset, or off-book accounting treatment. Conversely, a CMS debt instrument can be used in order to obtain a liability on the books without recognizing the income associated with a sale.

REMIC rules are discussed in greater detail in Chapter 42 of this Portfolio and in Silversmith, "REMICs: A Major Change in the Rules for Issuing Mortgage Backed Securities," 2 *Tax Mgmt. Real Est. J.* 294 (Dec. 1986). The reader is also referred to Mr. Silversmith's forthcoming Tax Management Portfolio, 117 T.M., *Mortgage Backed Securities,* for a full discussion of all tax issues involved.

J. Cancellation of Indebtedness

(Chapter 3, this Portfolio; Act §§405, 822, amending Code §§108, 1017, generally effective for discharges after 12/31/86 (farmers - for TYEA 4/9/86); Conf. Rep. pp. II-115 and II-324)

The Act repeals the provision allowing an election to exclude income from the discharge of business indebtedness from gross income in exchange for a reduction in basis of the taxpayer's assets. The prior rule is continued for title 11 cases, cases of insolvency, and with respect to the treatment of a reduction of purchase money debt as a purchase price adjustment. *Bona fide* farmers may treat discharge of indebtedness income as if they were insolvent, resulting in forgiveness of such income after reduction in tax attributes and basis (including basis in farmland).

K. Investment Credit Repeal

(Chapter 11, Part I, this Portfolio; Act §211-213, adding new Code §49, generally effective as to property placed in service after 12/31/85, in TYEA 12/31/85; Conf. Rep. p. II-50)

The investment credit may be a substantial factor in real estate development for certain taxpayers. With transition rules, it is repealed for assets placed in service after December 31, 1985. Because of the retroactive nature of the repeal, a grace period to pay any additional estimated tax due because of repeal has been provided. Code §49 was added to provide detailed transition rules. Credit carryovers from years prior to 1986 are reduced (for calendar year taxpayers by 17.5% in 1987, and 35% thereafter) to take account of reductions in tax rates.

L. Reduction and Limitation of the Rehabilitation Credit

(Chapter 11, part III, this Portfolio; Act §§251, 501, amending Code §§46(b) and 48, generally effective as to property placed in service after 12/31/86, in TYEA 12/31/86, except the placed-in-service date is extended until 1/1/94 in the case of certain property subject to a binding contract on 3/1/86; Conf. Rep. pp. II-82, II-142)

A revision of the rehabilitation tax credit was made for property placed in service after December 31, 1986, with special transition rules for property subject to a binding contract on March 1, 1986 that is placed in service before 1994. Gone is the three tier credit structure and the restriction on non-historic residential buildings. A 20% credit for qualifying expenses is provided for certified historic structures, and a 10% credit for other buildings placed in service before 1936 is also available. Two alternative "wall tests" are provided for the 10% credit: (1) at least 75% of existing external walls are left in place as external walls, or (2) at least 50% of existing external walls are left in place as external walls, at least 75% of existing external walls are left in place as external or internal walls, and at least 75% of the building's internal structural framework is retained in place. Certain additional rules apply for the 20% credit, including the requirement that the Interior Department certify that the rehabilitation is consistent with the historic character of the building or historic district in which the building is located.

Like the low income housing credit, the availability of the rehab credit to offset tax on up to $25,000 of non-passive income [21] does not depend on the taxpayer's "active" or "material" participation in the enterprise and is phased-out (for taxpayers filing joint returns) at adjusted gross income levels between $200,000 and $250,000. Otherwise, the credit is useful only against taxes on passive income.

An assessment of the probable impact of changes in the rehabilitation credit may be found in Chapter 11, Part III of this Portfolio, and in Borod, "Tax Incentives for Rehabilitating Older Properties After the Tax Reform Act of 1986," 2 *Tax Mgmt. Real Est. J.* 276 (Dec. 1986). The reader is also referred to Mr. Borod's Tax Management Portfolio, 477 T.M., *Rehabilitation Tax Credit,* for an extensive discussion of all tax issues involved.

[21] For an individual in the 28% bracket, an allowance of $25,000 is equal to a $7,000 tax credit.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

M. Changed Low-Income Housing Incentives

(Chapter 12, this Portfolio; Act §252, amending Code §§38 and 55(c), and adding Code §42, applicable for buildings placed in service after 12/31/86, in TYEA 12/31/86; Conf. Rep. p. II-84)

A new scheme of incentives for low-income housing was devised for buildings placed in service after 1986 to replace the expiring five-year amortization of rehabilitation expenditures, the preferential depreciation provisions, and special treatment of construction period interest and taxes. The incentives consist of credits which may be claimed annually over 10 years with respect to qualifying expenditures on low-income units. A 9% credit is available for property placed in service in 1987 for new construction or rehabilitation expenditures of at least $2,000 per unit. The credit is reduced to 4% for new construction or rehabs financed with tax-exempt bonds or other federal subsidies. A 4% credit is available for acquisition costs which may be combined with the other credits. For buildings placed in service after 1987, the credit percentages will be adjusted based on the applicable Federal rate of interest in effect from time to time. The credit does not reduce the depreciable basis of the property. The credit is generally effective for property placed in service after December 31, 1986 and before 1990.

Restrictions which appear to reduce the attractiveness of such housing as an investment are provided, including potential recapture for up to 15 years and restriction of qualifying tenants to those whose income places them on the lowest rungs of the socio-economic ladder. The minimum set-aside requirements for low-income tenants are: (a) 20% of the residential units are to be leased to families with incomes of 50% or less of area median gross income, or (b) 40% of such units are to be leased to families with incomes of 60% or less of area median gross income, adjusted for family size and local income or housing costs; the rent charged to low-income tenants may not exceed 30% of qualifying income.[22]

The minimum set-aside requirements must be met within 12 months of the date the new or rehabilitated property is placed in service and continuously complied with for 15 years with severe penalties for failure to maintain compliance. The penalty for failure to maintain the set-aside is full recapture of the credit during the first 10 years and partial recapture thereafter. Even if the set-aside requirements are met but the units are not fully occupied with qualifying individuals, the credits are recaptured proportionately for the first 10 years and partially thereafter. The statute presents a full set of rules dealing with various situations that may be presented during the 15-year period.

Investors in low-income housing receive some measure of relief from the passive loss rules. An amount of the credit sufficient to offset tax on up to $25,000 of non-passive losses[23] is treated as arising from rental real estate activities in which the taxpayer "actively participates"; the credit phase-out is accomplished at incomes between $200,000 and $250,000, instead of the lower limits for regular rental real estate activities.

Some rather curious exemptions from the passive loss rules protect certain individuals whose investment in a project is being made in installments after 1983, provided at least half of the amount is due after 1986, or who, on August 16, 1986, held an interest acquired after December 31, 1983, in a project placed in service before August 16, 1986. This relief terminates on the earlier of seven years after the date of the initial investment or one year after the investor makes the last payment. Widely varying tax treatment for different investors will apparently result.

These issues are discussed in greater detail in Chapter 12 of this Portfolio, and in Delta, "Real Estate and Tax Reform 1986: The Low-Income Housing Credit," 2 *Tax Mgmt. Real Est. J.* 249 (Nov. 1986).

N. Limitations on the Issuance of Tax-Exempt Bonds

(Chapter 30, this Portfolio, Act §§1301-1302, 1311-1318, amending Code §§ 103, 141-150, repealing §103A, generally effective for bonds issued after 8/15/86, a date applicable to most other bond provisions, except that some arbitrage provisions are retroactive to 9/25/85 or 12/31/85; Conf. Rep. p. II-683)

Generally, municipal bond interest from bond issues used to finance operations of state or local governments remains tax-exempt under Code §103. Interest on state and local government bonds is taxable if the bonds are "private activity bonds," unless specifically exempted, provided, however, that interest on exempt private activity bonds issued after August 7, 1986 (except qualified §501(c)(3) bonds) is a tax preference for purposes of the alternative minimum tax. Private activity bonds can be loosely described as those whose proceeds are intended to be used to benefit entities other than state and local governments. Another significant development in this area is that banks and other financial institutions will no longer be able to deduct interest incurred to purchase or carry tax-exempts acquired after August 7, 1986.

Private activity bonds issued for the following purposes remain exempt provided they fit within the volume quotas (where applicable): qualified redevelopment bonds; qualified mortgage bonds; qualified veterans' mortgage bonds; qualified student loan bonds; qualified §501(c)(3) organizations' bonds; exempt facilities bonds; hazardous waste disposal facilities; and some small-issue industrial development bonds. The exemption for small-issue industrial development bonds expired at the end of 1986, except for manufacturing facilities and beginning farmers (both of which have been given an additional three years). No longer exempt are bonds issued for air and water pollution control facilities, industrial parks, sports arenas and convention centers, and parking lots.

[22] For example, the 50% and 60% limits contemplate a family of four. A single person's qualifying percentage for the 20/50 set-aside is 70% of 50% of area median income. Thus, if area median income were $20,000, an eligible single person would have an income not exceeding $7,000 per year (20/50 set-aside) or $8,400 per year (40/60 set-aside). Maximum rents could not exceed 30% of the qualifying income, about $175 or $210 per month. The problem is exasperated with typical inner city families requiring large apartments.

[23] For an individual in the 28% bracket, an allowance of $25,000 is equal to a $7,000 tax credit.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The greatest burden placed on issuers of tax-exempt bonds by the Act is probably the volume limitations placed on the issuance of private activity bonds rather than the establishment of the general rule that interest on private activity bonds is taxable unless specifically exempted. Until December 31, 1987, each state is limited to the issuance of $75 per capita or $250 million. Thereafter, the limits are $50 per capita or $150 million.

The volume limits apply to bonds having a separate limitation under existing law, except veterans' mortgage bonds which remain outside the new quotas. Also exempt from the volume limits are exempt-facility bonds for publicly owned airports, wharves, and docks. Qualified §501(c)(3) bonds other than hospital bonds are subject to a $150 million per institution limit on bonds outstanding at any given time. The 1987 limit is substantially less than the volume of bonds issued by most states for exempt private activity bonds in 1986. The competition among interests for a share of a state's exempt private activity bond pool seems likely to be quite heated.

Note also the rules governing limitations on arbitrage, issuance costs, advance refundings, extended maturities, and qualification of multifamily housing developments.

These issues are discussed in greater detail in Chapter 30 of this Portfolio, and in Lyles, Baber, and Stern, "Real Estate and Tax Reform 1986: Tax Exempt Bonds," 3 *Tax Mgmt. Real Est. J.* 3 (Jan. 1987).

O. Changes Affecting Foreign Ownership of U.S. Real Estate - The Branch Profits Tax

(Chapter 62, this Portfolio; Act §1241, adding Code §884, effective for TYBA 12/31/86; Conf. Rep. pp. II-646)

Although the Act contains a number of significant changes in both domestic and foreign tax areas which will affect the U.S. taxation of foreign investment in U.S. real estate, clearly the most significant change is the branch profits tax ("BPT") set out in Code §884 and effective for taxable years beginning after 1986.

The BPT generally will be 30% of the after-tax U.S. profits of a foreign corporation which are not reinvested in U.S. business assets, and could result in a maximum corporate tax rate in excess of 50% if not overridden by an income tax treaty. A significant feature of the BPT provisions is the anti-treaty shopping provision requiring a corporation otherwise exempt by virtue of the existence of a treaty to be subject to the BPT if it is not at least 50%-owned by treaty country residents. Thus, substantial inhibitions are placed on the use by third country nationals of the U.S.-Netherlands Antilles Treaty, for example, to avoid American taxes.

The repeal of the "General Utilities Doctrine" [24] should prove of major significance to foreign investors in U.S. real estate in that it will preclude the routine bailout of accumulated profits through a §337 liquidation.

A more detailed assessment of the probable impact of the Act on foreign investment in U.S. real property is set out in Chapter 62 and other chapters of this Portfolio, and in Hudson, "Planning for Foreign Investment in U.S. Real Estate After the Tax Reform Act of 1986," 2 *Tax Mgmt. Real Est. J.* 283 (Dec. 1986). The reader is also referred to Mr. Hudson's Tax Management Portfolio, 481 T.M., *Federal Taxation of Foreign Investment in U.S. Real Estate,* for an extended discussion of all tax issues involved.

P. Construction Costs — Capitalization of Indirect Costs

(Chapter 19, this Portfolio; Act §803, adding Code §263A, and repealing Code §189, generally effective for costs incurred after 12/31/86 in TYEA 12/31/86; Conf. Rep. p. II-302)

The Act establishes "uniform capitalization rules" for the purchase and manufacture of inventory, including real estate constructed for sale, and the capitalization of direct and indirect costs incurred in the construction of real property used in a trade or business or activity engaged in for profit. Code §189, which permitted 10-year amortization of construction period interest and taxes, was repealed. Some costs that have heretofore been deductible by real estate developers as period costs must now be capitalized. General and administrative costs and overhead must be capitalized and allocated. Taxable income will, of course, be increased as will accounting complexity and the possibility of disputes over allocation with the Service. In some cases, a portion of indirect costs may have to be allocated to land and will not be recoverable until the property is sold.

Complex rules are established with respect to the capitalization of interest on debt incurred or continued to finance construction. If the debt that can be directly traced to construction expenditures is deemed insufficient, interest on other debt of the taxpayer is to be allocated to construction interest. In the case of flow-through entities such as partnerships, the capitalization rule is applied first at the partnership level and then at the partner level. Treasury is given authority to issue regulations to prevent the use of related parties, pass-through entities, or intermediaries to avoid the rules. Such capitalized interest loses its character as investment interest, but when recovered through depreciation it is, of course, affected by the passive loss and at-risk rules.

Q. Contributions in Aid of Construction Received by Utilities

(Portfolio Chapter 1, Part II and Chapter 34, Part I; Act §824, amending Code §§118, 362(c), generally effective as to amounts received after 12/31/86 in TYEA 12/31/86; Conf. Rep. p. II-324)

Pre-1986 TRA law allowed power, gas, pipeline, water, and sewage utility companies to treat payments made or property transferred to them to induce the utility to render service to or for the benefit of the transferor as contributions to capital rather than gross income. Contributions received after 1986 must be included in gross income in the year received. This change will indirectly increase the price of utility hookups for developers.

R. Long-Term Contract Accounting

(Chapter 20, this Portfolio; Act §804, adding Code §460, generally effective for contracts entered into after 2/28/86; Conf. Rep. pp. II-310)

[24] Act §631, adding Code §§336 and 337 and amending §311.

Due to widespread publicity, the defense industry has been considered the major beneficiary of the completed contract method of accounting. However, many building contractors have also taken advantage of the extended tax deferral opportunities available when the completed contract method is used in conjunction with certain contracting and accounting techniques. Because of the large amount of revenue involved, the completed contract method became one of the most hotly lobbied issues during the debates on tax reform.

In the compromise reached in the Act, the completed contract method survives as one available alternative for 60% of the contract items under the "percentage of completion-capitalized cost method" and for certain "small" construction contracts. Except for these small contracts, companies must use one of two new methods of accounting for long term contracts entered into after 2/28/86: (1) the percentage of completion-capitalized cost method, or (2) the modified percentage of completion method.

The percentage of completion method is no longer based on an estimate of the percentage of the contract completed at the close of a year but is derived from the ratio of costs incurred during the year to total estimated contract costs. The percentage is applied to the total revenues expected from the contract and that amount is includible in income. All contract costs incurred during the year are deductible.

In the alternative, the percentage of completion-capitalized cost method takes into account 40% of income for the year (as computed) and 40% of the year's costs. The balance (60%) of income and costs are taken into account under the completed contract method or any other authorized method of accounting, subject to the new capitalization rules.[25]

An exception from the required use of the two approved methods described above applies to certain small contracts for the construction of improvements to real property expected to be completed within two years of the commencement date of the contract by a contractor with average gross receipts over the preceding three taxable years of no more than $10 million.

S. REIT Rules Changes

(Chapter 41, this Portfolio; Act §§661-669, amending Code §§856-860, 4981, and 6697, generally effective for TYBA 12/31/86, except that changes respecting the tax on undistributed income are effective for calendar years beginning after 12/31/86; Conf. Rep. p. II-214)

The changes in the taxation of income and losses from real estate investments made by the Act are intended to stimulate interest in REITs as a vehicle for real estate investment. If this proves to be the case, it will be the result of Code changes which ease the restrictions on REITs and impose new strictures on other forms of real estate investments, *e.g.*, the passive loss limitations, less favorable depreciation rules, elimination of the capital gains differential, and imposition of an "almost escape-proof" minimum tax. Although the basic requirements for qualification as a REIT remain in place, a number of restrictions on operation were eased.

The Act makes it easier to achieve REIT status by waiving the §856(a)(5) and (6) tests during the first year following election. If an entity otherwise meets the applicable qualification requirements, it may elect REIT status even though five or fewer persons own more than 50% of its stock or if it has fewer than 100 shareholders or holders of beneficial interests, providing that it was not a REIT in any prior year.

The penalty provisions of Code §4981 respecting failure to make required distributions of income before the end of the taxable year were considerably stiffened by: (1) increasing the base to which the nondeductible excise tax is applied to 85% of the REIT's ordinary income for the calendar year, plus 95% of the REIT's capital gain net income, plus any prior year's shortfall; (2) raising the excise tax rate to four percent; and (3) changing taxable year to calendar year. A one month grace period is provided. Another concession granted was the elimination of the §6697 penalty relating to deficiency dividends.

For the first time, REITs will be permitted to hold assets through subsidiaries. All assets, liabilities, and items of income, deduction, or credit of a wholly-owned "qualified REIT subsidiary" are to be treated as assets, etc. of the REIT. Additional flexibility is provided with the introduction of the concept of "qualified temporary investment income" from new equity capital. The income received from investment of the proceeds is deemed to be income from real estate assets.

The REIT rules now permit ownership of shared appreciation mortgages. Income derived therefrom is treated as income from a sale of the underlying property by the REIT and may qualify as 95% income. The REIT's holding period of the obligation to which the shared appreciation provision relates must be at least four years for the safe harbor of §857(b)(6)(C) to apply. The Act places REITs on the same footing as exempt organizations with respect to unrelated business taxable income. This means that the REIT need no longer engage an independent contractor to provide certain basic services ("customary services") with respect to the property. A REIT will now be allowed to treat certain rents or interest based upon the net income or profits of a tenant or debtor as rents from real property (or as interest from a debtor).

The Act reduces the 95% distribution requirement by the amount that the sum of certain noncash types of income exceed five percent of REIT taxable income determined without regard to the dividends paid deduction or the net capital gain. The former general rule that a REIT must recognize any capital gain for the taxable year (except to the extent that it pays a capital gain dividend) has been modified so that a REIT can compute its net capital gain without an offset for net operating losses. If the REIT elects to pay capital gains dividends in excess of its net income, the REIT's NOL carryover will be increased by the amount of the dividend.

[25] Note that the difference between income computed using the percentage of completion method and the percentage of completion-capitalized cost method becomes a tax preference for purposes of the alternative minimum tax.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

The prohibited transactions "safe harbor" provided by §857(b)(6)(C) permitting not more than five sales of property (other than foreclosure property) during the taxable year is raised to seven sales. The aggregate amount of permitted expenditures includible in the property's basis during the four years prior to sale was raised from 20% to 30% of the selling price. A REIT may make an unlimited number of property sales during the taxable year as long as the adjusted bases of the properties sold do not exceed 10% of the total adjusted basis of all its properties. Losses from prohibited transactions are not to be taken into account in determining net income from prohibited transactions but may be included in the computation of REIT taxable income.

T. Modifications to Cooperative Housing Rules

(Chapter 39, this Portfolio; Act §644, amending Code §216, generally effective for TYBA 12/31/86; Conf. Rep. p. II-212)

Cooperative housing corporations are governed by a strict set of tax rules under Code §216 which may be seen to contrast unfavorably with the alternate form of co-ownership of dwelling units, the condominium. Although the layman may consider these forms of co-ownership almost identical, there are very substantial legal and tax differences between cooperatives and condominiums. The condominium apartment owner possesses legal title to his dwelling in fee simple and may sell, pledge or encumber it. On the other hand, the coop apartment dweller owns only shares of stock in the cooperative corporation and is referred to formally as a "tenant- stockholder." Because of this, his right to income tax deductions for a portion of the coop's property taxes and interest payments is governed by special provisions of the Code.

Under the Act, a person other than an individual (*e.g.*, a corporation, partnership, or trust) is now permitted to own a cooperative apartment. This should greatly ease the pressure on a coop with unsold apartments or apartments owned by a financial institution because of foreclosure. Code §216(b)(5) and (6) (dealing with stock acquired through foreclosure by a lending institution and stock owned by persons from whom the corporation acquired its property) have been repealed.

Section 216(d) was added to provide that no deduction is allowable to any stockholder for amounts paid to the coop which are chargeable to the coop's capital account. Any such amounts must be capitalized and added to the shareholder's stock basis. Another provision (§216(c)) makes clear that in the case of a unit used by the shareholder in his trade or business, depreciation is limited to the adjusted basis of the stock owned. A further change to §216(b)(3) permits the coop to allocate to a shareholder an amount of interest and taxes proportionate to the value of his unit rather than basing the allocation solely upon the number of shares the stockholder owns. The change in the §1239 related party rules may have some effect on condominium converters since the Act includes in the definition of related parties a person and all entities more than 50% (formerly 80%) owned by the same persons.

U. Other Provisions Affecting Real Estate

Numerous other provisions of the Act affect real estate transactions directly or indirectly. The attention of the reader is invited to the following additional issues discussed elsewhere in this Portfolio:

1. The Alternative Minimum Tax.[26]

2. Limitations on the Use of the Cash Method of Accounting.[27]

3. Restrictions on Use of a Non-Calendar Fiscal Year by Pass-through Entities.[28]

4. Related Party Sales.[29]

5. *General Utilities* Doctrine Repeal: New Rules for Corporate Liquidations.[30]

6. Penalties and Reporting Requirements.[31]

III. Summary and Conclusions

The foregoing treatment has necessarily been broad and devoid of detail and multiple citations and does not attempt to duplicate the material contained in the chapters of this Portfolio and other sources referenced therein. Its purpose is to alert the reader to the issues raised by the 1986 TRA changes and to encourage further research.

Some general conclusions may be offered, the most obvious being that real estate ownership and investment will never be the same again. There can be no return to the abuses of the past — egregious overvaluation such as six-to-one, eight-to-one, and twelve-to-one writeoffs, abandonment or disposal of burned-out "negative basis" shelters without the reporting of income, outrageous fraud and egregious scams that in the end benefitted no one but the promoters, and the virtual election-out of the tax system by a substantial number of the more venturesome affluent taxpayers.

It is easy enough to predict that the lowering of tax rates, the institution of passive loss limitations, and the elimination of the capital gains differential will greatly reduce the advantages real estate has had over other types of investments thereby causing real estate investors to look

---

[26] *See* Chapter 32, this Portfolio, and Act §701, adding Code §53 and amending Code §§55-59, generally effective for TYBA 12/31/86 (with exception for charitable contributions made before 8/16/86). *See* Conf. Rep. p. II-249.

[27] *See* Chapter 22, this Portfolio, and Act §801, adding Code §448, generally effective for TYBA 12/31/86. *See* Conf. Rep. p. II-285.

[28] *See* Chapter 23, this Portfolio, and Act §§806 and 1403, amending Code §§441, 706(b), and 1378(a), and adding Code §645, generally effective for TYBA 12/31/86. *See* Conf. Rep. pp. II-317 and II-766.

[29] *See* Chapter 25, this Portfolio, and Act §§642, 1812(c), amending Code §1239 and §707(b), generally effective for sales after 6/20/86. *See* Conf. Rep. p. II-210.

[30] *See* Chapter 36, this Portfolio, and Act §§631-632, amending Code §§311, 336-338, 1363, 1366, 1374. The transition rules are complex: the repeal of *General Utilities* is generally effective for liquidating sales and distributions after 7/31/86, however, liquidations completed and S elections made before 1/1/87 are excluded. *See* Conf. Rep. p. II-198.

[31] *See* Chapter 44, this Portfolio, and Act §§1501-04, 1511-12, 1521, 1525, 1531-34, adding Code §§6651(d), 6721-24, 6012(d), 6045(e) and amending Code §§6621(c), 6651, 6653, 6661, 6111(c), 6707(a) and (b), 6708, generally effective for returns due after 12/31/86, but in some cases after the date of enactment (10/22/86). *See* Conf. Rep. p. II-777.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

for solid values with positive cash flows instead of losses intended to shelter income and convert ordinary income into capital gain upon disposition. The fact is that the same properties exist waiting to be sold and resold. With the economics of real estate investment changed meaningfully, it seems not unlikely that property values will be affected and some individuals and entities will end up as losers. It is a considerable feat to take an untenanted "see-through" office building in overbuilt Houston, Texas and to convert it into a property generating positive cash flow and passive income. Someone (or rather many investors and lending institutions) is going to be left "holding the bag" in such instances.

In the short run, at least, what happens to the real estate investment industry will probably be largely dependent upon the regulations and rulings issued by Treasury within the next two years and the speed with which they are issued. If the government takes a hard line on what constitutes passive income and portfolio income and investment interest and personal interest, it is likely there will be a great deal of uncertainty and not a little hardship as taxpayers sit by with unusable passive losses and credits arising, at least in part, from real economic losses and negative cash flows.

Among the hardest hit will be highly compensated executives and professionals who have committed themselves to make future installment payments on leveraged investments, the losses from which may not be usable for a number of years. There have been some predictions that a large number of these installment pay-in type deals will come apart as investors refuse to send good money after bad. In the worst case scenario, this would result in a domino effect leading to the collapse of a large number of financial institutions which have bankrolled these investments during the installment pay-in period. As of this writing, there have been no reliable indications that this is going to happen. It was enough of a concern in the low-income housing area, however, that Congress added a provision exempting from the impact of the passive loss rules at least some low-income investors who were purchasing limited partnership interests on the installment basis.

Another substantial uncertainty produced by the Act is whether the new statutory scheme of incentives for low-income housing will result in any significant increase in the housing supply. Whether or not it is true, there is a widespread perception that individuals below the poverty line, particularly large inner city families headed by a single parent, tend to destroy property and leave it with little or no residual value (for, say, condominium conversion) after the statutory 15-year period for qualification for the credit ends. Unless there is substantial residual value, most investors feel that the economics of low-income housing are unfavorable.

A further negative factor is that the subsidy for low-income housing is in the form of a passive credit, the least desirable of all forms of "income" and one which can be utilized against positive income only in limited amounts and only by a small number of specially situated taxpayers. It is understood that some members of Congress have promised that if the 1986 TRA does not produce the required amount of low-income housing, tax incentives will be altered until they are deemed sufficient. The problem is, of course, that such a solution could mean the reintroduction of tax shelters and the undermining of public confidence in the inherent fairness of the tax system. Perhaps the best solution to the problem for providing decent housing for the poor does not lie in the tax area, but it is a problem which thus far has eluded a solution.

Numerous predictions have been made that various provisions of the Act will prove to be unworkable or inadequate and will be changed, including real estate, capital formation, and revenue raising provisions. The most frequent predictions are for increase in the tax rate and a return of the capital gains differential and the investment credit. It seems likely that the real estate industry will be viewed as a leading indicator of the economy in the next few years. The industry's health may signal whether extensive surgery will have to be conducted on the Tax Reform Act of 1986.

©Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

DETAILED ANALYSIS
KEYWORD INDEX

Index entries are followed by numbers which refer to a chapter and page number, with the chapter number appearing before the colon and the page number appearing after the colon.

A

Abatement of interest
See
—Interest

Accelerated Cost Recovery System (ACRS)
See also
—Alternative Depreciation System (ADS)
—Depreciation
—Depreciation recapture
In general 4:2, 3
Alternative minimum tax, AMTI computation 32:10, 36
Alternative tax for corporations, AMTI computation 33:13
Anti-churning rules
—In general 4:10, 11
—Acquisitions by reason of death 4:11
—Nonrecognition transactions by corporations or partnerships 4:10
—Nonresidential real property 4:11
—Property excluded from rules 4:11
—Related persons 4:11
—Residential rental property 4:11
—Revised ACRS allowing less favorable deductions than pre-TRA 1986 ACRS 4:11
—Sec. 1245 property 4:10
—Sec. 1250 property 4:10
Applicable conventions 4:3, 16
Classification of property and recovery periods
—In general 4:11, 13
—3-year property 4:14
—5-year property 4:14
—7-year property 4:14
—10-year property 4:14
—15-year property 4:14
—20-year property 4:14
—ADR class life determination 4:12, 13
—Property assigned statutorily to specific categories 4:14, 15
—Real property 4:3, 15
—Tables 4:13
Commencement and termination of recovery
—Placement in service 4:19
—Retirements and dispositions 4:19, 20
Deduction determination
—In general 4:3, 16
—Adjusted basis 4:18
—Applicable conventions 4:3, 16
—Applicable depreciation method 4:16
—Sample computations 4:17, 18
—Short taxable years 4:18
Depreciation recapture 28:1
Early application election
—In general 4:8
—Alternative minimum tax, effect on 4:8
—Assets benefiting from election 4:8
—Short taxable year, effect of 4:8
Elections
—In general 4:4
—Early application of revised ACRS 4:8
Eligible property 4:9
Excluded property
—Films, video tapes, sound recordings 4:10
—Public utility property 4:10
—Tangible property depreciated by method not expressed in term of years 4:9
Executive order imported property 4:22
Expensing provisions 4:4, 24
Finance lease rules 4:4
Foreign property 4:20
Improvements and additions to property 4:23
Leasehold improvements 4:4, 24
Legislative history
—1985 amendments 4:2
—ERTA 1981 amendments 4:1
—Technical corrections to pre-TRA 1986 ACRS 4:24
—TEFRA 1982 amendments 4:2
—TRA 1984 amendments 4:2
—TRA 1986 amendments 4:3, 4; 28:1
Nontaxable transfers 4:23
Partnerships and other pass-through entities 4:22
Passenger automobiles used in taxpayer's trade or business
—In general 4:4; 8:9, 10
—"Passenger automobile" definition 8:9, 10; 73:6
Pre-ACRS depreciation methods 4:1
Property not subject to revised ACRS under transition rules
—In general 4:5
—ADR class life requirement 4:6, 7
—Binding contract rule 4:5
—Equipped buildings and plant facilities 4:6
—Placement in service requirement 4:6, 7
—Property constructed or reconstructed by taxpayer 4:5
—Property identifiable with and necessary to carry out written supply or service contract or lease 4:6
—Property qualifying under rehabilitation credit transition rules 4:7
Reacquisition of property by taxpayer 4:24
Real property
—In general 4:3, 15
—Building converted to theme or amusement park 4:15, 16
—Low-income housing 4:16
—Manufactured homes 4:16
—Nonresidential real property 4:15
—Real estate issues 76:5
—Residential rental property 4:15
Recovery periods 4:3
Sales and leasebacks
—"Step into the shoes rule," elimination 4:24
—Transition rules 4:7
Salvage value of property 4:3
Statutory outline of revised §168 ... 4:4
Tax preferences 32:36; 33:5, 6, 9, 42
Tax-exempt bond financed property 4:22
Tax-exempt use property 4:21
Transition rules
—Property not subject to revised ACRS 4:5, 6
—Rehabilitation credit rules 4:7
—Sales and leasebacks 4:7

Accident and health benefits
See also
—Disability benefits
—Health insurance
—Nondiscrimination rules for certain statutory employee benefit plans
Benefit requirements of statutory employee benefit plans, special rules
—Coordination with other benefits 53:8
—Coverage requirements 53:7
—Part-time employees 53:8
Continuation of coverage following qualifying events 53:15, 17
Effective date of continued coverage rules 53:18
Exceptions to continued coverage rules 53:16, 17
Failure to comply with continued coverage requirements 53:16
Group health plan definition 53:18
Information return requirements for specified fringe benefit plans 44:17
Leased employees and controlled group rules application to continued coverage requirements 53:18
Nondiscrimination rules 53:1, 4, 7
Prior law 53:1, 3
Structured settlement companies, exclusion from gross income of physical injury or physical sickness liability assignments 2:4

Accounting
See also
—Financial statements
Deferred payments for services 24:6
Liabilities not incurred before economic performance, §461(h)
—Effective dates, TRA 1986 amendments 24:6
—Irrevocable payments to court-ordered settlement fund 24:5
—Part year change in method election 24:4

Accounting methods
See also
—Accrual method accounting
—Cash method accounting
—Completed contract method of accounting
—Dollar-value LIFO method of accounting
—Installment sales
—Percentage of completion-capitalized cost method of accounting
In general 22:1
Change of method
—Functional currency changes 60:2, 9
—Part year change of method election 24:4
Foreign branch corporations with functional currency other than U.S. dollar 60:27, 28, 29
Utilities 24:1, 2; 76:9

Accounting periods
Real estate investment trusts 41:2

Accounts payable and receivable
Foreign currency transactions 60:16

Accrual method accounting
In general 22:1
Amounts not likely to be collected, non-inclusion
—In general 22:5
—Determination of uncollectible amount 22:5
—Effective dates, TRA 1986 amendments 22:6
—Exception 22:5
Bad debt reserves, restriction on use 22:4
Long-term contracts, repeal 20:2
Preproductive period expenses 28:3
Utilities 24:1

Accrual of benefits
See also
—Vesting standards
Interest rate used for determination of present value 54:28, 30
Present value determination 54:28; 57:10
Qualified preretirement survivor annuities 57:8
Top-heavy plans 54:29, 30, 31
Vested accrued benefit in excess of $3,500 ... 54:28; 57:10

Accumulated earnings tax
Foreign corporations' taxable income, income included in computation 71:2
Interest on underpayment of tax 44:14, 15

Actuarial assumptions
Valuation of different contributions and benefits 54:4

Additions to tax and additional amounts
See
—Civil tax penalties

Affiliated groups of corporations
See also
—Consolidated returns
Definition 38:8
Domestic international sales corporations (DISCs) 38:8, 9

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Affiliated groups—Contd.
Effective dates, TRA 1986 amendments 38:10
Election of post-1984 Act rules 38:9
Excludable stock amendment 38:9
Golden parachute rules 51:12, 13
Grandfather rule clarifications 38:9
Installment sales method 18:4
Prior law 38:8
Sales or exchanges in connection with corporate liquidations, §337 ... 38:9
Separate activity determination 17:2
Stock purchases treated as asset acquisitions, §338 ... 38:9
Subsidiary liquidations, nontaxable, §332 ... 38:9

Agriculture
See
—Farming and ranching

Alaska native corporations
Alternative tax for corporations, AMTI determination 33:31

Alcohol
Non-beverage distilled spirits 73:5
Returns, Treasury Dept. authority to set place for filing 73:6

Alcohol fuels tax credit
See also
—Nonrefundable business credits
General business credit 15:3
Passive losses 15:6
Prior law 15:2

Alimony and separate maintenance
Front-loading rules 1:3
Post-death payments 1:3
Qualified domestic relations orders, see Qualified domestic relations orders

Allocations
Alternative tax for corporations 33:49
Cooperative housing corporation allocation of interest and taxes among stockholders 39:2
Excess distributions from passive foreign investment companies 64:5
Excise tax on certain prohibited allocation of qualified ESOP securities 52:6
Long-term contracts, interest allocations 20:4
Purchase price in asset acquisitions 27:1
Research and experimental expenditures, House reform proposals 61:11
Retroactive partnership allocations 43:1

Allocations under §482
See also
—Foreign corporation transfers, §367
In general 66:2; 68:1; 71:7
Arm's-length standard 66:2, 3; 68:2, 6
Bona fide cost sharing arrangements 66:3; 68:4, 6
Commensurate with income attributable to intangible 68:6
Correlative adjustments by foreign tax authorities 68:7
Effective dates, TRA 1986 amendments 68:5
Intangible property transfers 68:2, 4, 5
Possessions corporations 66:2
Profit split standard 68:5, 6
Second look rule 68:5
Tangible property transfers 66:3

Alternative Depreciation System (ADS)
See also
—Accelerated Cost Recovery System (ACRS)
In general 4:3, 20
Alternative minimum tax, AMTI computation 32:11
Alternative tax for corporations, AMTI computation 33:8, 14
Deduction determination 4:23
Election to use where not required 4:23
Property required to use 4:20, 21, 22
Real estate issues 76:6

Alternative minimum tax
See also
—Alternative minimum tax credit
—Alternative tax for corporations
—Tax preference items
Accelerated depreciation deductions
—Accelerated Cost Recovery System deductions 32:10, 36
—Adjustments to AMTI 32:6, 10
—Alternative Depreciation System deductions 32:11
—Planning considerations 32:14
—Tax preferences 32:7, 36
Adjustments to AMTI
—In general 32:9, 10
—Accelerated Cost Recovery System deductions 32:10
—Alternative Depreciation System deductions 32:6, 11
—Apportionment of differently treated items 32:43
—Circulation expenditures 32:6, 23
—Farm losses 32:6, 29
—Gains or losses from sale or exchange of property 32:6, 26
—Installment sales 32:6, 18
—Itemized deductions 32:6, 20
—Long-term contracts 32:6, 17
—Mining exploration and development costs 32:6, 14
—Net operating losses 32:6, 29
—Passive losses 32:6, 26
—Pollution control facilities 32:6, 14
—Research and development expenditures 32:6, 23
—State and local tax refunds 32:6, 23
Alternative minimum tax base 32:7, 9
Alternative minimum tax foreign tax credit
—In general 32:7, 40
—Computation of credit 32:40
Alternative minimum tax itemized deductions 5:8
Alternative Minimum Taxable Income (AMTI)
—In general 32:9; 75:14
—Definition 32:6
—Sec. 465 limitations 32:37
—Sec. 704(d) limitations 32:37
—Sec. 1366(d) limitations 32:37
—Trusts and estates 32:43; 47:4
Apportionment of differently treated items 32:43
Charitable contributions of appreciated property
—In general 32:35
—Definition 32:35
—Planning considerations 32:36
—Tax preferences 32:7, 35
Circulation expenditures
—Adjustments to AMTI 32:6, 23
—Definition 32:24
—Election under §59(e) 32:7
—Planning considerations 32:25
Depletion
—In general 32:30
—Definition 32:31
—Tax preferences 32:6, 30
Election of early application of TRA 1986 ACRS revisions 4:8
Estimated tax installment payments by corporations 45:2
Farm losses
—In general 32:29
—Adjustments to AMTI 32:6, 29
—Definition 32:29
Flat tax system, similarities to 32:7
Gains or losses from sale or exchange of property 32:6, 26
General business credits 15:8
Incentive stock options
—In general 32:33
—Definition 32:34
—Exercise 51:7
—Tax preferences 32:7, 33
Installment sales
—In general 18:5; 32:18
—Adjustments to AMTI 32:6, 18
—Definition 32:19
Intangible drilling costs
—In general 32:31
—Computation of IDC preference 32:32
—Definition 32:32
—Election under §57(b)(2) 32:33
—Election under §59(e) 32:7, 33
—Planning considerations 32:33
—Tax preferences 32:7, 31
Itemized deductions
—Adjustments to AMTI 32:6, 22
—Generation-skipping transfer tax 32:22
—Investment interest deduction 32:22
—Medical expense deduction 32:22
—Miscellaneous deductions 32:22
—Personal interest deduction 32:22
—Planning considerations 32:23
—Windfall profit tax 32:22
Long-term contracts
—In general 32:17
—Adjustments to AMTI 32:6, 17
—Definition 32:18
Mining development and exploration costs
—In general 32:14
—Adjustments to AMTI 32:6, 14
—Definition 32:16
—Election under §59(e) 32:7
—Mining development costs 32:15, 17
—Mining exploration costs 32:14, 16
—Planning considerations 32:16
Miscellaneous credits 15:8
Net operating losses
—In general 32:29
—Adjustments to AMTI 32:6, 29
—Definition 32:29
—Effective date 32:30
Nonrefundable tax credits 15:2, 3, 7; 32:7
Optional 10-year write-off of certain adjustments and preferences
—In general 32:37
—Basis adjustments 32:38
—Dispositions of underlying property 32:38
—Election 32:37, 39
—Recapture of amount subject to §59(e) election 32:39
Passive losses
—In general 32:26
—Adjustments to AMTI 32:6, 26
—Definition 32:28
—Effective dates 32:28
—Exceptions 32:27
—"Passive activity" 32:26
—"Passive credits" 32:27
—"Passive losses" 32:27
—Phase-in rules 32:28
—Suspended passive losses and credits 32:27
—Taxpayers subject to passive limits 32:26
Pollution control facilities
—In general 32:14
—Adjustments to AMTI 32:6, 14
—Definition 32:14
—Tax preferences 32:36
Prior law
—In general 75:14
—Revenue Act of 1978 amendments 32:2; 33:2
—TEFRA 1982 amendments 32:4; 33:3
—TRA 1969 amendments 32:1; 33:1
—TRA 1976 amendments 32:2; 33:2
—TRA 1984 amendments 32:4; 33:4
—TRA 1986, alternative minimum tax before 32:4, 8; 33:4
Rationale underlying tax 32:7; 75:14
Regular tax
—In general 32:6, 41
—Nonrefundable credits 32:21
—Taxes disregarded 32:21
Research and development expenditures
—Adjustments to AMTI 32:6, 23
—Definition 32:24
—Election under §59(e) 32:7
—Planning considerations 32:25
Short taxable year 32:44
Standard deduction 32:23
State and local tax refunds 32:6, 23
Tax benefit rule 32:43
Tax preferences
—In general 32:9, 30; 75:15
—Accelerated Cost Recovery System deductions 32:7, 36
—Apportionment of differently treated items 32:43
—Charitable contributions of appreciated property 32:7, 35

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Alternative minimum—Contd.
Tax preferences—Contd.
—Depletion deductions 32:6, 30
—Incentive stock options 32:7, 33
—Intangible drilling costs 32:7, 31
—Pollution control facilities 32:36
—Tax-exempt interest 30:13; 32:7, 34
Tax-exempt interest
—In general 32:34
—Definition 32:34
—Tax preferences 32:7, 34
Tentative minimum tax
—In general 32:6, 40
—Alternative minimum tax foreign tax credit 32:40
—Exemption amount 32:40
—Net AMT liability 32:41
Trusts and estates 32:43
Two-track tax system 32:7

Alternative minimum tax credit
In general 14:2; 32:7, 43; 33:9, 48; 75:15
Application of credit 14:4; 32:43; 33:48
Computation of credit 14:2, 3; 32:43; 33:48
Corporate acquisitions 14:4
Prior law 14:1

Alternative tax for corporations
See also
—Alternative minimum tax
—Alternative minimum tax credit
—Tax preference items
In general 33:10, 11
Accelerated depreciation deductions
—In general 33:13
—Accelerated Cost Recovery System deductions 33:13
—Alternative Depreciation System deductions 33:13
—Exceptions 33:16
—Personal property 33:15
—Planning considerations 33:16
—Real property 33:15
Add-on minimum tax
—In general 33:5
—Alternative tax, reasons for replacement, legislative history 33:7
—Computation of tax 33:7
—Foreign source deductions 33:7
—Tax benefit rule 33:7
Adjusted current earnings
—In general 33:31; 75:17
—Annuity contracts 33:34; 75:18
—Computation 75:17
—Debt pools exchange 33:34
—Definition 75:17
—Depletion 33:33
—Depreciation 33:32
—Exclusion items 33:32; 75:18
—Life insurance companies 33:34; 75:18
—Life insurance contracts 33:34; 75:18
—Other adjustments 33:33; 75:18
—Ownership changes 33:34
—Possessions corporations dividends 33:34
—Real estate investment trusts 33:34
—Real estate mortgage investment conduits 33:34
—Regulated investment companies 33:34
—S corporations 33:34
—Sec. 312(n) adjustments 33:33
Adjustments to AMTI
—In general 33:11, 12
—Accelerated Cost Recovery System deductions 33:13
—Alternative Depreciation System deductions 33:8, 14
—Capital construction funds 33:8, 24
—Circulation expenditures 33:8, 22
—Earnings and profits 33:9, 28
—Gains or losses from sale or exchange of property 33:8, 24
—Installment sales 33:8, 21
—Insurance providers, special deduction 33:9, 25
—Long-term contracts 33:8, 20
—Mining development and exploration costs 33:8, 17
—Net operating losses 33:8, 34
—Optional 10-year write-off 33:42
—Passive losses 33:8, 25
—Pollution control facilities 33:8, 17
—Possessions corporations tax credit 33:25
Alternative minimum tax on individuals compared
—Prior law 33:1
—Revenue Act of 1978 amendments 33:2
—TEFRA 1982 amendments 33:3
—TRA 1969 amendments 33:1
—TRA 1976 amendments 33:2
—TRA 1984 amendments 33:4
—TRA 1986, alternative minimum tax before 33:4
Alternative Minimum Taxable Income (AMTI)
—Adjustments 33:8, 11
—Computation 33:8, 11
—Definition 33:8
—Exemption amounts 33:9
—Sec. 465 limitations 33:42
—Sec. 704(d) limitations 33:42
—Sec. 1366(d) limitations 33:42
—Tax preferences 33:9, 11
Bad debt reserve deduction for financial institutions
—In general 33:5, 39
—Definition 33:39
Capital construction funds
—In general 33:8, 24
—Definition 33:25
Charitable contributions of appreciated property
—In general 33:9
—Definition 33:41
Circulation expenditures
—In general 33:8, 22
—Definition 33:23
—Planning considerations 33:23
Depletion
—In general 33:6, 35
—Definition 33:36
Earnings and profits
—In general 33:9, 28
—Adjusted current earnings, see subhead: Adjusted current earnings
—Alaska native corporations 33:31
—Applicable financial statement 33:29; 75:16
—Book income, 1987, 1988, 1989 ... 33:29; 75:15
—Cooperatives 33:31
—Corporations with affiliates 33:30
—Insurance companies 33:31
—Possessions corporations 33:31
—Regulatory authority to make adjustments 33:31
—S corporations, RICs, REITs, and REMICs 33:31
Estimated taxes 33:49, 49
Gains or losses from sale or exchange of property 33:8, 24
Installment sales 33:8, 21
Intangible drilling costs
—In general 33:9, 36
—Computation of IDC preference 33:37
—Definition 33:37
—Election under §57(b)(2) 33:38
—Election under §59 (e) 33:38
—Planning considerations 33:39
Long-term contracts
—In general 33:20
—Definition 33:21
Minimum tax base
—Additional tax preferences for personal holding companies 33:6
—Regular tax deduction 33:7
—Tax preferences 33:5
Mining development and exploration costs
—In general 33:8, 17
—Definition 33:18
—Mining development costs 33:18, 20
—Mining exploration costs 33:17, 19
—Planning considerations 33:19
Net book income adjustments 75:16
Net operating losses
—In general 33:8, 34
—Definition 33:34
—Effective date 33:35
Optional 10-year write-off of certain adjustments and preferences
—In general 33:42
—Basis adjustments 33:43
—Dispositions of underlying property 33:43
—Election 33:42, 44
—Recapture of amounts subject to §59(e) election 33:45
Passive losses
—In general 33:8, 25
—Definition 33:26, 28
—Effective dates, TRA 1986 amendments 33:27
—Exceptions 33:27
—"Passive activity" 33:25
—Phase-in rules 33:27
—Suspended passive losses and credits 33:27
—Taxpayers subject to limitations 33:26
Pollution control facilities
—In general 33:17
—Definition 33:17
Possessions corporations tax credit
—In general 33:25
—Definition 33:25
Property and casualty insurance companies 75:10
Reform, significance of 33:10
Repeal of rate differential for net capital gains 34:3
Short taxable year 33:49
Tax benefit rule 33:49
Tax preferences
—In general 33:5, 11, 12
—Accelerated Cost Recovery System deductions 33:5, 9, 42
—Bad debt reserve deduction for financial institutions 33:5, 9, 39
—Capital gains 33:6
—Charitable contributions of appreciated property 33:9
—Depletion deductions 33:6, 9, 35
—Intangible drilling costs 33:9, 36
—Optional 10-year write-off 33:42
—Pollution control facilities 33:5, 42
—Tax-exempt interest 33:9
Tax preferences for personal holding companies
—Accelerated Cost Recovery System deductions 33:6
—Circulation and research and experimental expenditures 33:6
—Intangible drilling and development costs 33:6
—Mining exploration and development costs 33:6
Tax-exempt interest
—In general 30:13; 33:9, 40
—Definition 33:40
Tentative minimum tax
—In general 33:45
—Alternative minimum tax foreign tax credit 33:45
—Exemption amount 33:45
—Investment tax credit 33:46
Treasury Dept. study 75:19

Amendment of qualified plans
See
—Employee benefit plans

American Samoa
In general 70:1
Amounts covered into American Samoa treasury by U.S. 70:8
Corporations
—In general 70:4
—Anti-abuse provisions 70:5
—Withholding tax exemption 70:4
Effective date, TRA 1986 amendments 70:3
Grant of authority to pass own tax laws 70:2
"Mirror" tax system 70:1, 2
Possession-source income, exclusion from gross income 70:3

Amortizable bond premium
In general 54:29
Basis of bond received in exchange for property 31:2, 3
Call date used instead of maturity date 31:2, 3

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Amortizable bond—Contd.
Computation of bond premium amortization 31:2, 3
Foreign currency transactions 60:9
Interest treatment 31:2
Investment interest 5:8
Prior law 31:1
Taxpayer's yield to maturity 31:2, 3

Amortization
See also
—Depreciation
Bond premiums, see Amortizable bond premiums
Intangible drilling costs, see Intangible drilling costs
Mineral exploration and development expenditures, see Mineral exploration and development expenditures
Pollution control facilities 32:14; 33:5, 17
Railroad grading and tunnel bores amortization repeal 7:4
Tax preferences 33:5
Trademark and trade name expenditures, repeal of 5 year amortization 8:4

Annuities
See also
—Joint and survivor annuities
—Qualified preretirement survivor annuities
—Tax-deferred annuities
Annuity starting date 57:8, 10
Death of holder before distribution of entire interest, exemption of qualified plan and IRA annuities from §72(s) distribution requirements 1:2
Deferred annuities
—In general 57:22
—Contracts held by non-natural persons 57:23; 75:28
—Immediate annuities distinguished 57:22
—Prior law 57:22
Distribution rules 75:30
Estate tax on annuities created pursuant to community property laws 57:11
Excess distributions excise tax, periodic distribution limits 57:18, 19
Exchanges under §1035 ... 75:31
Exclusion ratio 75:29
Premature distributions from nonqualified or qualified annuity plans, see Withdrawal restrictions of qualified plans
REA 1984 survivor annuity requirements, exceptions to 54:29, 30, 31, 32; 57:9
Structured settlements 75:30
Transfers without adequate consideration 75:30

Applicable Federal Rate (AFR)
Semi-annual compounding of AFR 31:8

Appreciated property
See
—Charitable contributions
—Subsidiary liquidations

Arbitrage bonds
Computation of bond yield 30:11
Definition 30:11
Higher yielding investments 30:11
Nonpurpose investments limitation 30:12
Optional penalty in lieu of loss of tax exemption 30:12
Reasonably required reserve and replace funds 30:11
Rebate requirements 30:11
Temporary period exceptions 30:11

Armed forces
Military fringe benefits exclusion from gross income 51:3

Assessment of tax
See
—Civil tax penalties
—Deficiency assessments

Assets
Allocation of purchase price 27:1
Qualified plan assets reversion to employer, exception to §4980 excise tax where assets transferred to ESOP 52:4; 57:21

At-risk limitation
Nonrecourse financing limitation 15:3, 4
Passive loss coordination 17:9
Real property activities
—In general 16:1
—Holding of real property 16:2
—Loans to partnerships 16:3
—Partnership special rule 16:2
—Prior law 16:1
—Qualified nonrecourse financing 16:2, 3
—Qualified person 16:2
—Real estate issues 76:3, 4
—Seller financing 16:3

Attribution of stock ownership
See
—Constructive stock ownership

Automobile product testing
See
—Fringe benefits

B

Backup withholding
See
—Withholding taxes

Bad debts
See also
—Reserves for bad debts
Deposits in insolvent financial institutions 74:6

Bankruptcy
Insolvent financial institutions
—Casualty loss deduction 74:6
—Interest on frozen deposits 74:6
Net operating loss carryforward limitation exception 35:8, 9

Banks
See also
—Payee statements
—Reserves for bad debts
—Savings and loan associations
Foreign sales corporations principal bank account 72:15
Guamanian banks, interest on U.S. obligations paid to 70:1
Insolvent financial institutions, deposits in 74:6
Payee statement requirements for foreign interest and dividends collected for U.S. taxpayers 44:13
Tax-exempt interest 74:3

Basis
Bond received in exchange for property 31:2, 3, 5, 6
Extraordinary dividends 37:2
Passive foreign investment company stock 64:6
Stock purchases treated as asset acquisitions, §338 ... 36:4

Below-market interest rate loans
Demand loans 31:8
Israeli-issued obligations exception to §7872 provisions 31:8
Self-dealing definition for private foundations not to take §7872 provisions into account 31:7
Semi-annual compounding of Applicable Federal Rate (AFR) 31:8

Beneficiaries
Information returns
—Fiduciaries of estates and trusts 44:10
—Nominees of beneficiaries 44:13
Nonspouse beneficiaries
—Joint and survivor annuities 57:9
—Qualified preretirement survivor annuities 57:8, 11

Bonds
See also
—Arbitrage bonds
—Builder bonds
—Exempt facility bonds
—Market discount bonds
—Original issue discount
—Private activity bonds
—Qualified 501(c)(3) bonds
—Redevelopment bonds
—Short-term obligations
—Stripped bonds
—Student loan bonds
—Tax-exempt bonds
—Tax-exempt interest
Amortizable bond premium 5:8; 31:1
Basis of bond received in exchange for property 31:2, 3, 5, 6
Call date used instead of maturity date 31:2
Israeli-issued obligations exception to §7872 provisions 31:8

Books and records
Functional currency of qualified business unit 60:7
Leased employees 54:34

Branch profits tax
In general 62:1
Amounts excluded from income 62:3
"Branch," lack of definition 62:6
Branch level interest tax 62:3
"Dividend equivalent amount" 62:1, 2
Effective date, TRA 1986 amendments 62:5
Prior law 62:1
Profits tax as tax on capital 62:7
Real estate issues 76:9
Second level withholding tax
—Application under treaties 62:4
—Dividends received from foreign corporation 62:5
—Real estate sales 62:5
—Threshold 62:4
Tax base 62:1
Tax treaties, interaction with
—In general 62:3
—Nondiscrimination clauses forbidding imposition of branch tax 62:3, 5
—Second level withholding tax applicability 62:4, 6
—Treaties allowing imposition of branch tax 62:4
—Treaty shopping 62:3, 6
Termination of U.S. trade or business by foreign corporations 62:2
Treasury Dept. regulatory authority 62:5
"U.S. net equity" computation 62:1, 2, 6

Brokers
Information returns 44:10, 11

Builder bonds
Installment sales method 18:1

Built-in gains
S corporations
—Built-in gain tax, effect of 38:3
—Dispositions, §1374 ... 38:1
—Effective date, TRA 1986 amendments 38:4
—Inventory treatment 38:2
—Net unrealized built-in gain limitations 38:2
—Nonrecognition transactions after conversion, property acquired 38:2
—Offsets against recognized built-in gains 38:3
—Prior law 38:3
—Qualified corporations, transition rules 38:4
—Rates of tax 38:1
—Recognized built-in gains 38:1

Bus and freight forwarder operating authorities
60-month deduction for loss on value of operating permits 7:4

Business meals, entertainment, and travel expenses
See
—Entertainment expenses
—Meals and lodging
—Travel expenses

Business purpose doctrine
Separate lines of business 53:10; 54:5, 36

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

C

Cafeteria plans
See also
—Nondiscrimination rules for certain statutory employee benefit plans
Definition 53:3, 13
Group legal services 51:2
Information return requirements for specified fringe benefit plans 44:17
Life insurance salesperson status as employee for purposes of §125 provisions 51:4
Nondiscrimination rules 53:2
Prior law 53:2
Qualified benefits 51:5

Cancellation of indebtedness
Qualified farm indebtedness discharge by solvent farmers 3:1
Real estate issues 76:7
Reduction of tax attributes by solvent farmers 3:2
Repeal of basis reduction election by solvent taxpayers other than farmers upon discharge of qualified business indebtedness 3:1

Capital contributions
See also
—Transfers to controlled corporations
Cooperative housing stockholder contributions to capital accounts 39:2
Public utilities, gross income treatment for contributions in aid of construction and exceptions 1:1, 2; 34:1

Capital expenditures
See also
—Intangible drilling costs
—Land clearing expenditures
—Research and development expenditures
—Soil and water conservation expenditures
In general 19:3
Interest on debt
—In general 19:3, 7
—Allocation of interest 19:8
—Expenditures covered 19:7
—Flow-through entities 19:8
—Production period 19:7
Legislative history
—Effective dates, TRA 1986 amendments 19:3, 8; 28:3
—Reasons for change 19:2
Preproductive period expenses for certain plants and animals
—In general 19:3, 5; 28:2
—Definitions 19:5; 28:3
—Election to deduct expenses on depreciation 28:3
—Recapture of deducted expenses 28:3
Prior law 19:1, 2
Real estate issues 76:9
Sales and transfer taxes 19:3, 8
Simplified capitalization method for retailers and wholesalers
—In general 19:6
—Calculation of inventory 19:6
—Costs allocable to inventory 19:7
Stock redemption expenditures 34:2, 3
Transition rules
—In general 19:8
—Example 19:9
Uniform capitalization rules for direct and indirect costs
—In general 19:3, 4
—Election out of coverage for certain farmers 19:6
—Employee benefit expenses 19:4
—Excluded costs 19:5
—Extended period long-term contracts as regulatory model 19:4
—Small retailers and wholesalers 19:6

Capital gains and losses
Capital losses offset of capital gains 2:4
Coal and iron ore royalties 7:4
Financial planning considerations 2:4
Foreign currency gain on certain transactions 60:13
Lump sum distributions from qualified plans 57:5
Real estate investment trusts 41:5
Real estate issues 76:2
Repeal of capital gains deduction 2:4; 34:3; 57:5
Tax preferences 33:6
Wetland or cropland dispositions 28:2

Captive insurance companies
In general 63:3
Regulatory authority 63:4
Related person insurance income, taxation
—In general 63:4
—Exceptions 63:4
Types of companies 63:4

Carryovers and carrybacks
See also
—Net operating losses
Business credits, research credits, foreign taxes, and capital loss carryforward limitations 15:3; 35:9
Financial institutions 74:4
Foreign tax credit 59:22
Net operating loss limitations 35:1, 3, 5

Cash method accounting
In general 22:1, 2
Effective dates, transition rules, TRA 1986 amendments 22:4
Entities qualified to use 22:2
Farming businesses 22:3
Original issue discount deduction of obligors on short-term obligations 31:4
Prior law 22:1
Qualified personal service corporations 22:3
Small businesses 22:3
Tax shelters 22:2

Cash or deferred arrangements, §401(k)
See
—401(k) plans

Casualty losses
Deposits in insolvent financial institutions
—Effective dates, TRA 1986 amendments 74:6
—Election 74:6
—Extent of deduction 74:6
—Qualified financial institution 74:6
—Qualified individual's deposit 74:6
Personal casualty losses 9:3

Charitable contributions
Alternative minimum tax, AMTI computation 32:35
Alternative tax for corporations, AMTI computation 33:9, 40
Scientific research equipment
—In general 9:5
—Effective dates, TRA 1986 amendments 9:6
—Planning considerations 9:6
—Qualification requirements 9:5
—Qualified donees 9:5
Tax preferences 32:35; 33:9, 40

Circulation expenditures
Alternative minimum tax, AMTI computation 32:23
Alternative tax for corporations, AMTI computation 33:8, 22
Tax preferences 33:6

Civil tax penalties
Failure to exhaust administrative remedies before filing suit 46:2, 3
Failure to file certain information returns, §6721 replacement of §6652 ... 44:3
Failure to file furnish certain payee statements, §6722 replacement of §6678 ... 44:3, 5
Failure to file return, §6651(a)(1) 44:4, 7
Failure to include correct information, §6723 ... 44:6
Failure to pay estimated tax, individuals, §6654 ... 45:1
Failure to pay tax, §6652(a)(2)
—In general 44:4
—Coordination with §6651(a)(1) failure to file penalty 44:4, 7
—Increase in penalty if notice of intent to levy sent or notice and levy made 44:6, 7
—Tax Court jurisdiction over addition to tax 46:3
Failure to report information with respect to includable employee benefits, §6652(l) 53:4
Failure to supply identification numbers, §6676 ... 44:6
Fraud, §6653(b)
—In general 44:4, 8
—Coordination with negligence penalty 44:9
—Increase in percentage amount 44:7
—Underpayment portion attributable to fraud 44:7
Interest rate on underpayment of tax 44:14, 15
Limitations period for assessment 44:9
Negligence or intentional disregard of rules and regulations, §6653(a)
—In general 44:4, 8
—Coordination with fraud penalty 44:9
—Disregard definition 44:8
—Payee failure to include interest or dividends in income, §6653(g) special penalty 44:4, 8
—Scope of penalty 44:8
Overstatement of pension liabilities, §6659A 54:32
Qualified investment entities, liabilty for tax, assessable penalty, §6697 ... 41:3; 44:5
Substantial understatement of tax liability, §6661 ... 44:5
Tax shelter-related penalties, see Tax shelters

Clinical expenses testing tax credit
Alternative minimum tax 15:8
Passive losses 15:6
Prior law 15:1

Closely-held businesses
See also
—Special use real property valuation election
Definition 17:4
Passive activity losses 15:5; 17:4, 9
Pre-1989 liquidations of qualified corporations 36:5

Coal and iron ore
Corporate capital gains treatment of royalties repeal 7:4
Percentage depletion 7:4

Collapsible corporations
Effective date 38:12
Holding period 38:12
Prior law 38:11

Collectively bargained plans
In general 54:29
Bona fide collectively bargained agreements 54:30, 31

Commercial pilots plans
Sec. 415 limitations 54:16

Commodity futures contracts
Foreign currency, §988 transactions 60:22

Community property
Estate tax on annuities created pursuant to community property laws 57:11

Complete liquidation distributions
Capital gains deduction repeal 2:4
Installment obligations 18:8

Completed contract method of accounting
See also
—Long-term contracts
Long-term contracts, repeal 20:2
Prior law 20:1

Compliance rules
See
—Civil tax penalties

Compounding of interest
See
—Interest

Consolidated returns
Affiliated groups of corporations
—In general 65:1
—Dual consolidated losses, restrictions 65:1, 2

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Consolidated returns—Contd.
Consolidated distributees as 80-percent distributees for subsidiary liquidation purposes 36:3, 4
Taxpayer identification numbers on federal agency contract information returns 44:12

Constructive receipt doctrine
Tax-deferred annuities, repeal of application of doctrine 56:4; 57:7

Constructive stock ownership
Net operating loss carryforward limitation rules 35:5
Passive foreign investment company stock 64:8, 9
Qualified closely-held small corporation business pre-1989 liquidations 36:5

Continuity of business enterprise
Net operating loss carryforwards 35:5

Continuity of interest requirement
Reorganizations of thrift institutions 74:5

Contracts
See
—Federal contracts
—Long-term contracts

Contributions to qualified plans
Employee contributions
—401(k) plans 54:19, 21, 24, 25
—Basis recovery rules 57:5, 6
—Employee-funded plans 57:11
—Federal Thrift Savings Fund contributions 54:32
—Tax-deferred annuity salary reduction arrangement contribution limitation 56:1, 2
—Thrift plans 54:20
Employer contributions
—401(k) plans 54:19, 20, 21, 21
—Annual compensation limit 54:17
—Capitalization of costs requirement 19:4
—Carryforward of excess contributions repeal 54:37, 38
—Combined plan limitation 54:37, 38
—Deductibility 54:36
—Defined benefit plans 54:12, 14, 16, 37, 38
—Defined contribution plans 54:12, 13
—Excise tax on nondeductible contributions 54:37, 38
—Matching contributions 54:20, 21, 25, 36
—Money purchase pension plans 54:37, 38
—Overstatment of pension liabilities, §6659A penalty 54:32
—Profit-sharing plans 54:29, 30, 31
—Sec. 415 limitations 54:12, 13, 14, 16
—Thrift plan matching contributions 54:20, 25
Excess contributions 54:19, 20, 21, 24, 25
Withdrawal restrictions 57:12, 13

Controlled foreign corporations
In general 64:1, 2
Accumulated deficit rule for reducing Subpart F income
—In general 63:5, 6
—Pre-acquisition deficits of acquired corporation 63:6
—Recharacterization rule 63:7
—Sample computations 63:7
—Shareholder's pro rata share of deficit 63:6
"Applicable CFC" defined 72:2
Captive insurance companies 63:3, 4
Chain deficit rule, repeal 63:5, 6
Definition 63:8; 64:2; 72:2
Earnings and profits 60:30
Effective dates, TRA 1986 amendments 63:8, 9
Foreign base company services income, §954
—In general 72:11
—Related party definition 72:12
—TRA 1984 amendments 72:11
Foreign tax credit 60:32, 33, 34
Gain on sale or exchange of stock 64:2
Possessions corporations 63:9
Prior law 63:1
Related person factoring income
—In general 72:3
—Certain exclusions from acquisition of trade or service receivables constituting U.S. property 72:4
—Same country exception 72:4
—Separate limitation treatment for amounts treated as interest 72:4
—TRA 1984 amendments 72:4
Related persons 63:5
Sales or exchanges of stock of certain foreign corporations, §1248
—In general 72:10
—Indirect transfer, recasting 72:10
—TRA 1984 amendments 72:10
Stapled entities
—In general 72:10
—Classification of foreign corporation as stapled entity 72:11
—Exception to treatment of stapled foreign corporation as domestic corporation 72:11
—Liability for foreign corporation's tax 72:11
—TRA 1984 amendments 72:11
Stock ownership test 71:1
Subpart F income
—Amounts received from related parties 63:3
—Commodities transactions gains 63:2
—De minimis rule 63:8
—Dividends 63:2
—Foreign base company shipping income 63:5
—Foreign currency gains and losses 63:2
—Income equivalent to interest 63:2
—Income subject to foreign tax of at least 90 percent of maximum U.S. rate 63:5
—Insurance income 63:3
—Interest 63:2
—Passive income included 63:1
—Prior law 63:1
—Reduction through accumulated deficit rule 63:5
U.S. source interest paid to applicable CFC by an affiliated corporation, resourcing rules 72:2

Conventions
See
—Travel expenses

Cooperative housing corporations
Allocation of interest and taxes among stockholders 39:2
Alternative tax for corporations, AMTI determination 33:31
Capital expenditure contributions by stockholders 39:2
Depreciation of unit used in trade or business 39:2
Information returns 44:14
Non-individual ownership of unit 39:1
Qualified cooperative housing corporation refinancing 39:2
Real estate issues 76:11

Cooperatives
See
—Worker-owned cooperatives

Corporate liquidations
See
—Liquidations, corporate

Corporate minimum tax
See
—Alternative tax for corporations

Corporate preferences
See
—Tax preference items

Corporate reorganizations
See
—Reorganizations, corporate

Corporations
See also
—Affiliated groups of corporations
—Built-in gains
—Collapsible corporations
—Controlled foreign corporations
—Distributions, corporate
—Domestic International Sales Corporations (DISCs)
—Dual resident corporations
—Estimated tax for corporations
—Foreign branch corporations
—Foreign corporations
—Liquidations, corporate
—Personal holding companies
—Personal service corporations
—Possessions corporations
—Reorganizations, corporate
—S corporations
—Subsidiaries, corporate
—Transfers to controlled corporations
Rates of taxes 34:3; 38:1; 75:13
Taxable income 65:1

Cost of living adjustments (COLAs)
401(k) plans 54:19
Defined benefit plan §415 limitations 54:16

Coverage requirements
See
—Participation standards

Credits against taxes
See also
—Alcohol fuels tax credit
—Alternative minimum tax credit
—Clinical expenses testing tax credit
—Earned income credit
—Elderly and permanently and totally disabled credit
—Energy investment tax credit
—ESOP tax credit
—Foreign tax credit
—General business credit
—Household and dependent care credit
—Investment tax credit
—Low-income housing credit
—Mortgage certificate tax credit
—Nonconventional fuels source tax credit
—Orphan drug tax credit
—Passive activity losses and credits
—Political contributions tax credit
—Possessions corporation tax credit
—Rehabilitation tax credit
—Research and development tax credit
—Residential energy tax credit
—Targeted jobs tax credit
Alternative minimum tax 15:2, 3, 7; 32:7
Carryforward limitations for certain credits 13:3; 35:9
Diesel fuel excise tax 73:2

Currency transactions and translation
See
—Foreign currency transactions and translation

D

Damages
Physical injury or physical sickness liability assignments exclusion from gross income by structured settlement companies 2:4; 75:30

Death benefits
See also
—Disability benefits
Waivers by surviving spouses 57:11

Debt instruments
See also
—Amortizable bond premium
—Bonds
—Cancellation of indebtedness
—Original issue discount
—Short-term obligations
Basis of instrument received in exchange for property 31:2, 3
Call date used instead of maturity date 31:2, 3
Definition 31:1
Economic accrual of interest 31:1
Foreign currency transactions 60:16, 18, 19

Deductions
See also
—Capital expenditures
—Source of income and deductions rules
—Specific deductions
Accelerated Cost Recovery System deductions, see Accelerated Cost Recovery System (ACRS)

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Deductions —Contd.
Administration expenses 47:4
Adoption expenses, repeal 9:1
Alimony payments 1:3
Alternative Depreciation System deductions, see Alternative Depreciation System (ADS)
Alternative minimum tax itemized deductions
—In general 5:8; 32:22
—Generation-skipping transfer tax 32:22
—Investment interest 32:22
—Medical expenses 32:22
—Miscellaneous deductions 32:22
—Personal interest 32:22
—Planning considerations 32:23
—Windfall profit tax 32:22
Amortizable bond premium, see Amortizable bond premium
Bad debt deductions, see Bad debts
Bus and freight forwarder operating authorities loss on value of operating permits 7:4
Business gifts from employers to employees restrictions 2:3
Capital gains deduction repeal 2:4; 34:3
Casualty losses, see Casualty losses
Charitable contributions, see Charitable contributions
Contributions to qualified plans, see Contributions to qualified plans
Costs other than interest required to be inventoried or capitalized 8:8
Demolition losses and expenses 8:11
Depletion, see Depletion
Depreciation, see Depreciation
Dividends-received deduction, see Dividends-received deduction
Employee achievement awards 8:4
Entertainment expenses 6:1, 3
ESOP stock dividends used to repay exempt loans 52:3
Estate tax
—50% deduction for proceeds of sale of employer securities to ESOP or worker-owned cooperatives 52:2
—Conservation easement contributions 49:2
Farming syndicate expenses restrictions 7:1, 2
Gift tax 49:2
Health insurance expenses, 25 percent deduction for self-employed individuals 51:2
Hobby losses
—In general 8:1
—Breeding, training, showing, or racing horses 8:1
—Presumption of for profit intent 8:1, 2
Home office
—In general 8:2, 3
—Amount of deduction 8:3, 4
—Carryforward of unused deductions 8:4
—Prior law 8:2
Intangible drilling costs 7:3
Investment interest 32:20
Life insurance contracts, denial of deduction for interest on loans 5:8
Losses, see Losses
Meals expenses 6:1, 2
Medical expenses 9:1; 32:20
Membership organizations, exceptions to §277(a) 8:8
Mining and solid waste reclamation and closing costs 24:4
Miscellaneous itemized deductions
—In general 9:3; 32:20
—Actors and performing artists 9:5
—Definition 9:3, 4
—Effective dates, TRA 1986 amendments 9:5
—Trusts and estates 9:4
—Two percent floor 8:2; 32:20
Mortgage interest 9:2
Personal interest 32:21
Preproductive period expense deductions 28:2
Property tax 9:2
Qualified discount coupons outstanding at close of year, repeal 8:7, 8
Qualified nuclear decommissioning fund contributions 24:4
Removal of architectural and transportation barriers 8:4
Reserve for bad debts, see Reserve for bad debts
Soil and water conservation, repeal deduction for certain expenditures 7:1
Standard deduction 32:23
State and local sales taxes, repeal 8:9; 9:2; 32:20
Tax shelters 24:3
Travel expenses 6:1, 4
Trustee fees 47:4
Two-earner married couple deduction, repeal 9:1
Vacation pay accrued, timing of deduction 51:4

Deferred annuities
See
—Annuities

Deferred compensation
See also
—Nonstatutory stock options
—Restricted property
Deferred annuities 57:22, 23
Premature distributions from nonqualified annuity plans, see Withdrawal restrictions of qualified plans
Scope of §457 ... 51:9
State and local government plans, addition of exempt organizations to §457 coverage 51:8
Transfers between eligible deferred compensation plans 51:9

Deficiency assessments
Limitations period 46:1
Notice of deficiency 46:1, 2

Defined benefit plans
Forfeiture of nonvested benefits 54:29
Integration of qualified plans 54:9, 10, 11
Minimum funding standard 54:37
Minimum required distributions 57:3
Money purchase pension plan funding requirements 54:37, 38
Overstatement of pension liabilities, §6659A penalty 54:32
Sec. 415 limitations 54:12, 14, 16
Top-heavy plans 54:29, 30, 31
Withdrawal restrictions 57:12

Defined contribution plans
Forfeiture of nonvested benefits 54:29, 30, 31
Integration of qualified plans 54:9
Minimum required distributions 57:3
Qualified preretirement survivor annuities 57:8
Sec. 415 limitations 54:12, 13
Withdrawal restrictions 57:12

Definitions
Accelerated depreciation deductions 32:12; 33:13
Accident year 75:7
Adjusted current earnings 75:17
Annuity starting date 57:8, 10
Applicable CFC 72:2
Applicable exclusion 44:17
Applicable financial statement 33:29
Arbitrage bond 30:11
Automobile salesman 51:4
Average employer-provided benefit 53:5
Cafeteria plan 53:3, 13
Capital construction funds for shipping companies 33:25
Certain insurance companies, special deduction for 33:25
Charitable contributions of appreciated property 32:35; 33:41
Circulation expenditures 32:24; 33:23
Closely held C corporations 17:4
Compensation 54:2, 23, 36
Controlled foreign corporation 59:10; 63:8; 64:2
Customer 51:5
Debt instrument 31:1
Demand loan 31:8
Dependent children 51:5
Depletion 32:30; 33:36
Designated blighted area 30:8
Designated payor corporation 72:2, 3
Direct skip 48:7
Disqualified benefit 53:15
Disqualified lease 4:21
Disregard 44:8
Dual consolidated losses 65:1
Elective deferral 54:19
Eligible deferred compensation plan 51:8
Eligible employer 51:8
Employee discount 51:5
Employer 53:18
Excess aggregate contribution 54:24, 25
Excess benefit of highly compensated employee 53:7
Excess contribution 54:24
Farming business 28:3
Federal executive agency 44:11
Five percent owner 57:15
Foreign currency gain 60:10
Foreign currency loss 60:10
Foreign investment company 64:2
Foreign personal holding companies 63:8
Generation-skipping transfer 48:5
Government official 50:5
Group health plan 53:18
High withholding tax 59:13
Highly compensated employee 53:8; 54:1, 20, 23, 36
Highly compensated individual 51:14
Incentive stock options 32:34
Installment sales 32:19
Intangible drilling costs 32:32; 33:37
Interest (in property) 48:5
Investment company permitted income 40:4
Key employee 51:15
Life insurance 75:27
Line of business 75:7
Listed property 8:11; 73:6
Long-term contracts 32:18; 33:21
Members of family 28:3
Mining development and exploration costs 32:16; 33:18
Miscellaneous itemized deductions 9:3
Net operating losses 32:29
Non-skip person 48:6
Nonresidential real property 4:15
Passenger automobiles 8:9, 10; 73:6
Passive activity 17:1, 2; 33:25
Passive credits 32:27
Passive farm activity losses 32:29
Passive foreign investment companies 64:3
Passive income 59:4; 64:3
Passive losses 32:27
Personal interest 5:6
Personal service corporations 17:5; 23:4
Pollution control facilities, amortization of 32:14; 33:17
Possession of the United States 66:2
Possessions corporations 33:25
Pre-enactment interests 17:15
Premiums paid 75:27
Preproductive period 28:3
Qualified 501(c)(3) bond 30:9
Qualified business unit 60:4
Qualified covered call 26:1
Qualified discount coupons 8:7
Qualified employer plans 57:18
Qualified possession source investment income 66:2, 6, 8
Qualified residence interest 5:6
Real estate brokers 44:11
Related persons 28:3; 63:5
Research and development expenditures 32:24
Reserves for bad debts 33:39
Residential rental property 4:15
Retirement distribution 57:18
Sec. 988 hedging transaction 60:2, 25
Short-term obligation 31:4
Skip person 48:6
Specified fringe benefit plan 44:17
Straddles 26:1
Tax-exempt bond financed property 4:22
Tax-exempt entity 4:21
Tax-exempt interest 32:34; 33:40
Taxable distributions 48:6
Taxable terminations 48:6
Transferor 48:5
Trust 48:5
Trustee 48:5
Undiscounted unpaid losses 75:6
U.S. person 70:4
U.S. shareholder 59:10

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Definitions —Contd.
Welfare benefit fund 53:14

Department stores
Line of business requirement for qualified employee discounts 51:4

Dependent care assistance programs
See also
—Nondiscrimination rules for certain statutory employee benefit plans
Benefits test for plans not statutory employee benefit plans 53:6
Election to apply §89 nondiscrimination rules 53:4
Exclusions from gross income, cap on 51:3
Information return requirements for specified fringe benefit plans 44:17
Nondiscrimination rules 53:2
Prior law 53:2

Dependents
Taxpayer identification number requirement for dependents five years old and older 44:12, 13

Depletion
See also
—Percentage depletion
Alternative minimum tax, AMTI computation 32:30
Alternative tax for corporations, AMTI computation 33:6, 9, 35
Foreign intangible drilling costs and mineral exploration and development expenditures 7:3
Recapture on disposition of oil, geothermal and mineral properties 28:2
Tax preferences 32:30; 33:6, 9, 35

Depreciation
See also
—Accelerated Cost Recovery System (ACRS)
—Alternative Depreciation System (ADS)
Cooperative housing unit used in trade or business 39:2
Pre-ACRS depreciation methods 4:1

Depreciation recapture
Capital gains
—Repeal of deduction 2:4
—Treatment, effect on 28:1
General Utilities doctrine repeal 28:1

Depreciation recapture, §1245 property
Nonresidential real property 28:1
Prior law 28:1

Depreciation recapture, §1250 property
Nonresidential real property 28:1
Prior law 28:1

Disability benefits
See also
—Accident and health benefits
—Death benefits
Annuity starting date 57:10
Auxiliary disability benefits 57:8, 10

Discounts
Class of employees entitled to discounts 51:5
Employee discount definition 51:5
Line of business requirement for qualified employee discounts 51:4

Distributions, corporate
See also
—Built-in gains
—Complete liquidation distributions
—Dividends
—Extraordinary dividends
Appreciated property distributions 36:1; 37:1, 5
Foreign currency translation 60:3, 30, 32
Partnership interests 37:6
Penalty assessable with respect to qualified investment entities 41:3
Real estate investment trusts 41:3, 4
Trust interests 37:6

Distributions of property in liquidation
See also
—Complete liquidation distributions
—Liquidations, corporate
—Sales or exchanges in connection with corporate liquidations, §337
Gain recognition on appreciated property contributed in contemplation of complete liquidation 36:2
General Utilities doctrine repeal 36:1, 2
Joint and survivor annuities, immediate distribution of 57:9
Loss recognition limitations 36:1
Prior law 36:1
Recognition of gain or loss on distribution of property in complete liquidation 36:1
Reduction of basis of certain property acquired in §351 transfer or contribution to capital to generate loss in connection with liquidation 36:2
Sec. 336(e) election to treat certain stock sales, exchanges, or distributions and asset transfers 36:3

Distributions, partnerships
See also
—Partnerships
Foreign partners, withholding tax 69:3, 4
Nonliquidating distributions, limitation on gain recognized 43:1

Distributions, pension & profit-sharing plans
See also
—Individual retirement arrangements
—Lump sum distributions
—Rollovers
—Top-heavy plans
—Withdrawal restrictions of qualified plans
10 percent additional tax on premature distributions, exemption for certain ESOP distributions 52:5
401(k) plans 54:20
Annuities
—Exemption of qualified plan and IRA annuities 1:2
—Starting date 57:8
Basis recovery of employee contribution rules
—Effective date, TRA 1986 amendments 57:7
—Post-annuity starting date distributions 57:6
—Pre-annuity starting date distributions 57:5
—Three-year basis recovery rule repeal 57:6
—Transition rule 57:6
Beginning date 57:1, 2
Disputed benefit payments 57:10
Early retirement exception to premature withdrawal penalty tax 57:14
Employee-funded plans 57:11
ESOPs 52:4, 5, 7; 57:14
Estate tax treatment 57:11
Excess contributions distributed before end of following plan year 54:24, 26
Excess distributions excise tax 57:17, 18
Excise tax on required amounts not distributed 57:2, 3
Golden parachute payments, exemption for qualified plan distributions 51:12, 13
Hardship distributions 57:12
Immediate distributions 57:10
Incidental benefits rule 57:1
Joint and survivor annuities 57:1, 9
Loans to plan participants, see Loans to qualified plan participants
Net unrealized appreciation on employer securities 57:7
Partial distribution rollovers 57:7, 11
Periodic payments exception to premature withdrawal penalty tax 57:13
Premature distribution penalty 57:11, 13
Qualified domestic relations orders 57:10, 20
Qualified preretirement survivor annuities 57:8
Required distributions
—Defined benefit plans 57:3
—Defined contribution plans 57:3
—Effective dates, TRA 1986 amendments 57:3
—Nonqualified §457 plans 51:8; 57:2
—Prior law 57:1
Rollovers to IRAs 57:7, 11
Self-employed taxpayer rollovers 57:11
Survivor benefit requirements and exemptions 57:9, 11
Taxation of distributions
—Basis recovery rules 57:5, 6
—Employee contributions exclusion 57:5, 6
—Estate tax 57:11
—Excess distributions excise tax 57:17, 18
—Individual retirement arrangements 57:6
—Net unrealized appreciation of employer securities, election not to apply §402(e)(4)(J) exclusion 57:7
—Premature withdrawal penalty tax 57:14
—Prior law 57:3
—Ten year forward averaging for lump sum distributions repeal 57:4
—Unrecovered investment in the contract amounts 57:6
Timing of distributions 51:9; 57:1, 8, 10, 15
Transferee plans 57:9
Waivers by surviving spouses 57:9, 11
Withdrawal restrictions of qualified plans 54:27; 57:12, 13

Distributions, trusts
Nonliquidating distributions, limitation on gain recognized 43:1

Dividends
See also
—Extraordinary dividends
—Patronage dividends
—Payee statements
ESOP stock, §404(k) employer deduction for dividends used to repay exempt loans 52:3
Failure to file information returns and payee statements, §6724 special rules 44:6
Failure to include interest or dividends reported on information return in income, §6653(g) penalty 44:4, 8
Foreign tax credit look-through rules 59:7, 15
Information reporting requirments 44:10, 13
Investment companies
—Constructive inclusion in shareholder's income of certain dividends declared but not yet paid 40:3
—Preferential dividends 40:5
Payee statement mailing requirements 44:13
Real estate investment trusts
—Capital gains dividend notices 41:5
—Deemed distributions 41:3
Repeal of $100 dividend exclusion 2:5

Dividends-received deduction
Foreign corporations
—Debt-financed portfolio dividends received from foreign sales corporations and wholly-owned foreign subsidiaries 34:2
—Effective dates, TRA 1986 amendments 67:3
—Foreign tax credit, coordination with 67:3
—Percentage of dividends deductible on distributions from foreign corporations with income effectively connected with U.S. trade or business 34:2
—Prior law 67:1
—Qualified 10 percent owned foreign corporation 67:2
—U.S. source portion 67:2
Holding period 34:2
Prior law 34:1
Reduction of amount of deduction 34:2

Divorce and separation
See
—Alimony and separate maintenance

Dollar-value LIFO method of accounting
In general 21:2
Effective date, TRA 1986 amendments 21:5
Elections 21:2
Eligible businesses 21:2
Index selection 21:3
Ineligible taxpayer, rules applicable 21:4
Inventory pools 21:3
Inventory value computation 19:9; 21:3
Prior law 21:1
Reasons for change 21:1
Transition rules 21:5
Year of change, rules applicable 21:3, 4

Domestic international sales corporations (DISCs)
Accumulated DISC income, treatment of 72:15
Affiliated groups of corporations 38:8, 9
Corporate preference reductions 72:15

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Domestic international—Contd.
Interest charge on former DISC 72:15
Tax-year conformity requirement 72:16

Dual resident corporations
In general 65:1
Dual consolidated losses 65:1, 2

E

Earned income credit
Employee notification 14:5
Increased amount of credit 14:5
Inflation adjustments 14:5
Prior law 14:4

Earnings and profits
Alternative tax for corporations, AMTI computation 33:9, 28
Distributions of corporate property, effect on earnings and profits
—Appreciated property distributions 37:5
—Effective date, TRA 1986 amendments 37:5
—Prior law 37:5
Foreign corporation translation into U.S. dollars 60:2, 3, 30, 32
Real estate investment trusts 41:3

Easements
Conservation easement contributions, estate and gift tax deductions 49:2

Educational assistance programs
See also
—Nondiscrimination rules for certain statutory employee benefit plans
Cap on exclusion 51:2
Election to apply §89 nondiscrimination rules 53:4
Extension of time for exclusion from income 51:2
Information return requirements for specified fringe benefit plans 44:17
Nondiscrimination rules 53:2
Prior law 53:2

Educational expenses
Travel as form of education expenses, see Travel expenses
Tuition expenses reduction program anti-discrimination rules 51:5

Elderly and permanently and totally disabled credit
Prior law 15:1

Elections
Accelerated depreciation deductions
—Alternative Depreciation System (ACS) deductions 4:23
—Revised ACRS, early application 4:8
Alternative minimum tax, optional 10-year write-off of certain adjustments and preferences, §59(e) 32:37
Alternative tax for corporations, optional 10-year write-off of certain adjustments and preferences, §59(e) 33:42
Basis reduction election by solvent taxpayers other than farmers upon discharge of qualified business indebtedness repeal 3:1
Constant interest basis accrual of ratable share of acquisition discount 31:4
Cut timber gain treatment as §1231 gain, transition rules 34:3
Deducting cost of outstanding qualified discount coupons, repeal 8:7, 8
Deferral of tax by shareholder on undistributed PFIC earnings 64:7
Distributions in kind, election by executor or trustee 47:3
Dollar-value LIFO method 21:2
Employer contributions to SEP 55:5
ESOP accounts, partial diversification election for investments by qualified participants 52:5
Estate tax special use real property valuation, perfection of defective elections 49:1, 2
Excess distribution excise tax, grandfather limits election 57:19
Foreign corporations electing domestic corporation treatment, FIRPTA 72:7
Foreign currency gain on certain transactions, election to treat as capital gain 60:13
Functional currency, foreign qualified business unit election to use U.S. dollar 60:2, 8
Group health plans, election for continued coverage following qualifying events 53:16, 17
Intangible drilling costs expensing by domestic producers 7:2
Investment credit pass-through to lessee 11:4
Land clearing costs expensing election repeal 7:1
Net unrealized appreciation on employer securities, election not to apply §402(e)(4)(J) exclusion 57:7
Nondiscrimination rules for statutory employee benefit plans 53:4
Possessions tax credit 66:1
Qualified electing fund status 64:7
Qualified preretirement survivor annuities and qualified joint and survivor annuities
—Spousal consent for immediate distribution 57:9
—Spousal consent for waiver of survivor annuity 57:9
Resident alien, treatment as 72:13
Soil and water conservation costs expensing for qualified approved conservation plans 7:1
Statutory employee benefit plan status for educational assistance programs, group legal services plans, and dependent care assistance programs 51:3

Employee benefit plans
See also
—Accrual of benefits
—Contributions to qualified plans
—Distributions, pension & profit-sharing plans
—Employee-funded plans
—Funding of qualified plans
—Nondiscrimination rules for certain statutory employee benefit plans
—Specific types of qualified plans
—Vesting standards
Amendment of plans 54:34, 35, 36
Annual compensation limit taken into account for deduction of employer contributions 54:17
Collectively bargained plans 54:29, 30, 31
Contributions or benefits determination 54:3
Disqualifying provisions 54:34, 35
Fishing boat crew members 54:32
Prior law 54:1
Qualified plan regulations to be issued 54:36
Statutory employee benefit plan status election for educational assistance programs, group legal services plans, and dependent care assistance programs 51:3

Employee contributions
See
—Contributions to qualified plans

Employee leasing
In general 54:33
Effective dates, TRA 1986 amendments 54:34
Recordkeeping requirements 54:34
Safe harbor exceptions to qualified plan coverage for leased employees 54:33, 34
Years of service 54:34

Employee-funded plans
Employee-funded percentage requirement 57:11
Premature distribution penalty exception 57:11

Employees
See also
—Federal employees
—Key employees
"Automobile salesperson" 51:4
Employment taxes 58:1
Excludable employees from qualified tax-deferred annuities 56:4
Golden parachute payments, performance of personal services 51:14
Life insurance salesperson status as employee for purposes of cafeteria plan requirements 51:4
Technical personnel 58:3

Employer contributions
See
—Contributions to qualified plans

Employer securities
See
—Securities

Employment taxes
See also
—Federal Insurance Contributions Act (FICA)
—Federal Unemployment Tax Act (FUTA)
—Self-Employment Contributions Act (SECA)
—Withholding taxes
Employees 58:1
Exceptions
—Churches and church organizations 58:2, 3
—Clergymen 58:2, 3
—Technical personnel 58:2, 3

Energy investment tax credit
In general 11:1, 6
Passive losses 15:6

Entertainment expenses
See also
—Meals and lodging
—Travel expenses
80% limitation on deductibility of expenses and exceptions 6:1, 3
Skybox rental expenses restrictions 6:1, 3
Ticket costs in excess of face value of ticket 6:1, 3

ESOP tax credit
General business credit 15:3
Prior law 15:2
Repeal of credit, §41 ... 52:4

ESOPs
See also
—PAYSOPs
—Securities acquisition loans
In general 52:1
10 percent additional tax on premature distributions, exemption for certain ESOP distributions 52:5
Coverage requirements 54:6
Distributions upon plan termination 52:4
Diversification of employee account election 52:5
Diversification requirements 52:5
Dividends used to repay exempt loan, §404(k) employer deduction 52:3
Estate tax deduction for proceeds of sale of employer securities to ESOP or worker-owned cooperatives 52:2
Estate tax liability assumption from executor, §6166 deferred payment election requirement for §2210 application 52:7
Exception to excise tax on reversion of qualified assets to employer where assets transferred to ESOP 52:4; 57:21
Excise tax on prohibited allocations of qualified securities 52:6
Independent appraiser valuation of employer securities not readily tradable in securities markets 52:6
Installment payment of estate tax, §6166 ... 52:7
Net unrealized appreciation on employer securities, election not to apply §402(e)(4)(J) exclusion 57:7
Nonrecognition of gain or loss on sale of qualified securities to ESOP under §1042 ... 52:7
Partial rollovers to satisfy diversification requirements 57:7
Premature withdrawal penalty tax exceptions
—Dividends from §404(k) corporations 57:14
—Investment of plan assets in employer securities for five years 57:14
Put option distribution requirements 52:5
Timing of distributions 52:4
Voting pass-through requirement nonapplication to employees in certain newspaper publishing business 52:6

Estate tax
See also
—Extension of estate tax payment

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Estate tax—Contd.
Annuities created pursuant to community property laws 57:11
Deductions
—50% deduction for proceeds of sale of employer securities to ESOP or worker-owned cooperatives 52:2
—Conservation easement contributions 49:2
ESOP assumption of executor liability, §6166 deferred payment election eligibility requirement for §2210 application 52:7
Excess distribution penalty, additional estate tax on post-death distributions 57:19
Qualified plan distributions 57:11
Special use real property valuation election, see Special use real property valuation election

Estates
Administrative expenses 47:4
Alternative minimum tax 32:43; 47:4
Distributions in kind 47:3
Estimated income tax liability 45:2; 47:3
FIRPTA withholding requirements 72:8
Information returns
—Fiduciaries to beneficiaries 44:10
—Fiduciaries to nominees of beneficiaries 44:13
Miscellaneous itemized deductions 9:4
Passive activity losses 15:5
Rates of taxes 47:1, 2
Rental real estate activity 17:8

Estimated tax for corporations
Alternative tax for corporations 33:49
Exempt organizations and private foundations liability for unrelated business taxable income and net investment income excise tax 45:2; 50:4
Waiver of penalties for underpayments due to retroactive changes in TRA 1984 and TRA 1986... 45:2

Estimated tax for estates and trusts
See
—Estimated tax for individuals

Estimated tax for exempt organizations
See
—Estimated tax for corporations

Estimated tax for individuals
Annualized income installments 45:1
Estates and trusts 45:2; 47:3
Nonresident aliens 45:3; 72:16
Required annual payment 45:1
Waiver of penalties for underpayments due to retroactive changes in TRA 1984 and TRA 1986... 45:2

Estimated tax for private foundations
See
—Estimated tax for corporations

Excess distributions excise tax
In general 57:17, 18
Effective dates 57:20
Estate tax on post-death excess distributions 57:19
Excludable retirement distributions 57:18
Grandfather limit election 57:19
Lump sum distribution limitation 57:18, 19
Periodic distribution limitation 57:18, 19
Planning considerations to avoid tax 57:18
Premature withdrawal penalty tax, coordination with 57:18
Prior law 57:17
Regulations, issuance of 54:36

Excise taxes
Accumulations in qualified retirement plans, §4974 ... 57:2, 3
Air transportation tax 73:5
Diesel fuel tax
—In general 73:1
—Alternate collection method 73:4
—Exemptions 73:2, 5
—Light weight diesel vehicle credit 73:2
Excess contributions to certain plans, §4979 ... 54:20, 24, 26
Excess distributions from qualified retirement plans, §4981 ... 54:36; 57:16, 17
Fringe benefits provided by employer, §4977 ... 51:5
Funded welfare benefit plans, taxes with respect to, §4976 ... 53:15
Gas guzzler tax
—Exceptions 73:6
—"Passenger automobile" definition 8:9, 10
Gasohol tax 73:1, 4
Gasoline tax
—In general 73:1, 3
—Exemptions 73:4
Insurance policies
—In general 71:8
—Study of reinsurance industry 71:9
Investment companies, excess of required over actual distributions 40:2
Net investment income tax on private foundations, §4940 ... 45:2
Non-beverage distilled spirits 73:5
Noncommercial aviation fuel tax 73:5
Nondeductible contributions to qualified employer plans, §4972 ... 54:37, 38
Piggyback trailers or semitrailers 73:2, 5
Private foundations self-dealing excise tax, §4941
—Below-market interest rate loans, self-dealing definition not to take into account 31:7
—Government official definition 50:5
Prohibited allocation of qualified securities, §4979 ... 52:6
Real estate investment trust failure to distribute income 41:3
Reversion of qualified plan assets to employer, §4980 ... 57:21
Sport fishing equipment 73:6
Windfall profit tax 73:5

Exclusions from gross income
See also
—Gross income
50 percent exclusion for interest paid on employer securities acquisition loans received by regulated investment companies 52:3
Capital gains deduction repeal 2:4; 34:3
Dependent care assistance program payments 51:2, 3
Dividends, repeal of $100 exclusion 2:5
Educational assistance program payments 51:2
Employee achievement awards 2:3
Foreign earned income 71:3
Foster care payments amendments 2:5
Fringe benefits 51:1
Housing allowances, effect on mortgage interest and property tax deductions 9:2
Interest on installment payments of life insurance proceeds paid to surviving spouse, repeal of former §101(d)(1)(B) exclusion 2:3
Interest on state or local bonds 30:1
Legal services plan payments 51:2
Military fringe benefits 51:3
Net unrealized appreciation on employer securities, election not to apply §402(e)(4)(J) exclusion 57:7
Physical injury or physical sickness liability assignments received by structured settlement companies 2:4
Possessions-source income for certain bona fide possessions residents 70:3
Prizes and awards restrictions 2:2
Qualified campus lodging provided by employer 51:3
Qualified employee discounts 51:4
Qualified scholarships 2:1
Tax benefit items 2:5
Telephone service for pre-divestiture retirees of Bell System 51:5
Tuition expenses reductions 51:5
U.S. citizens employed by Canal Zone Commission 71:7
Working condition fringe benefits 51:4

Executors
ESOP assumption of estate tax liability, §6166 deferred payment election eligibility requirement for §2210 application 52:7

Exempt facility bonds
See also
—Private activity bonds
In general 30:4
Advanced refunding prohibition 30:12
Area medical gross income (AMGI) percentages 30:4, 5
Change in use of property resulting in loss of exemption 30:12
Deep rent skewed projects 30:6
Effective dates, TRA 1986 amendments 30:7
Federal guarantee prohibition 30:12
Governmental facilities leased to private persons 30:6
Information reporting requirements 30:12
Lists of exempt and no longer exempt facilities 30:4
Low and moderate income housing 30:4
Qualified hazardous waste facilities 30:7
Registration requirements 30:12
Substantially all of the proceeds requirement 30:4
Tenant ceasing to qualify as low-income tenant 30:6
Volume cap 30:9

Exempt organizations
401(k) plan ineligibility 54:21, 27
Deferred compensation plans under §457 ... 51:8
Estimated tax installment payments due on unrelated business income tax 45:2; 50:4
Excise tax on nondeductible contributions to qualified employer plans 54:38
Organizations providing commercial-type insurance 75:10
Qualified 501(c)(3) bonds 30:9
Sec. 415 limitations of exempt organization qualified plans 54:15
Sec. 501(c)(18) plans 55:6
Title-holding corporations formed by multiple exempt organizations
—Debt-financed income rules exemption 50:2
—Exempt status 50:1
—Planning considerations 50:2
Unrelated business income tax exceptions
—In general 50:3
—Low-cost articles, distribution 50:4
—Mailing lists sale or rental 50:3
—Trade show income 50:4

Exemptions
See
—Personal exemptions

Expenses
See also
—Capital expenditures
—Production of income expenses
—Public transportation expenses
Administrative expenses 47:4
Demolition expenses 8:11
Entertainment expenses 6:1, 3
Meals expenses 6:1, 2
Medical expenses 32:20, 22; 57:14
Travel expenses 6:1, 4

Extension of estate tax payment
See also
—Estate tax
Eligibility to make installment payments by ESOP and estate on respective interests in estate 52:7
Employer securities transfer to ESOP not disposition triggering accelerated payments 52:7
ESOP assumption of executor estate tax liability, §6166 deferred payment election eligibility requirement for §2210 application 52:7

Extraordinary dividends
See also
—Dividends
Reduction in stock basis for nontaxed portion
—In general 37:2
—Additional rules 37:4
—Determination of extraordinary dividend 37:2
—Effective dates, TRA 1986 amendments 37:4
—Holding period 37:3
—Non-pro rata redemptions 37:4
—Partial liquidations 37:4
—Prior law 37:2

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Extraordinary dividends—Contd.
Reduction in—Contd.
—Qualifying preferred stock 37:3
—Specific exceptions 37:4

F

Farming and ranching
See also
—Timber farming
Cancellation of indebtedness. see Cancellation of indebtedness
Capital expenditures
—Election out of uniform rules for certain farmers 19:6
—Exception for certain farm property 19:5
Farming syndicate expenses deduction restrictions 7:1, 2; 24:3
Land clearing expenses, see Land clearing expenditures
Passive activity losses
—Alternative minimum tax, AMTI computation 32:29
—Material participation determination 17:5
Preproductive period expense deductions 19:5; 28:2
Soil and water conservation, see Soil and water conservation expenditures

Farming syndicates
See
—Farming and ranching

Federal agencies
See
—Federal contracts

Federal contracts
Federal executive agency definition 44:11
Information return requirments for federal agency heads 44:11

Federal employees
Federal Thrift Savings Fund contributions 54:32
Three year employee retirement plan contribution basis recovery rule repeal 57:6

Federal Insurance Contributions Act (FICA)
See also
—Employment taxes
In general 58:1
Church and church organization exception 58:2, 3
Clergymen 58:2, 3
Effective dates, TRA 1986 amendments 58:2
Technical personnel 58:2, 3

Federal Unemployment Tax Act (FUTA)
See also
—Employment taxes
In general 58:1
Effective date, TRA 1986 amendments 58:2
Indian tribal governments 58:2, 4

Fees and costs
Capitalization of stock redemption expenditures 34:2
Limitations on awards 46:3
Trustee fees 47:4

Fellowship grants
See also
—Scholarships
Gross income exclusion for qualified scholarships 2:1
Gross income inclusion of payments for services 2:2

Fiduciaries
Information returns
—Beneficiaries of estates and trusts 44:10
—Nominees of beneficiaries of estates and trusts 44:14

Filing of returns
See also
—Information returns
—Returns
In general 10:7
Effective date, TRA 1986 amendments 10:8

Financial institutions
See also
—Banks
—Savings and loan associations
Deposits in insolvent financial institutions 74:6
Interest on frozen deposits 74:6
Net operating loss carryover rules 74:4

Financial planning
Capital gains deduction repeal 2:4
Incentive stock options v. nonstatutory stock options 51:7

Financial statements
Alternative tax for corporations 33:29; 75:16

Financing
Nonrecourse financing limitation
—In general 15:3, 4
—Lessees 15:4
—Partnerships and S corporations 15:4
—Qualified commercial financing exception 15:4
—Qualified nonrecourse financing 16:2, 3
—Subsequent years 15:4
Seller financing 16:3

Firearms
Returns, Treasury Dept. authority to set place for filing 73:6

Fishing boat crew members
Self-employed status for purposes of qualified plans 54:32

Foreign branch corporations
See also
—Branch profits tax
—Foreign currency transactions and translation
Income or loss determination, translation of functional currency into U.S. dollars 60:3, 27, 29
Remittances 60:3

Foreign corporation transfers, §367
Effective date, TRA 1986 amendments 68:5
House reform bill 68:4
Intangible property transfers 66:3; 68:3
Prior law 72:8
Sec. 355 distributions of stock or securities to non-corporate shareholders 72:8
Second look rule 68:5
TRA 1984 amendments 72:8

Foreign corporations
See also
—Controlled foreign corporations
—Foreign branch corporations
—Foreign corporation transfers, §367
—Foreign sales corporations
Accumulated taxable income, income included in computation 71:2
Branch profits tax, see Branch profits tax
Currency translation, see Foreign currency transactions and translation
Distributions, translation of foreign currency into U.S. dollars for U.S. taxes 60:30, 32
Dividends received from, see Dividends-received deduction
Earnings and profits, translation of foreign currency into U.S. dollars for U.S. taxes 60:32
Subpart F, U.S. person defined 70:4

Foreign currency transactions and translation
Books and records maintenance in functional currency 60:7
Change of function currency 60:2, 9
Distributions from foreign corporations 60:3, 30, 32
Earnings and profits translation into U.S. dollars 60:2, 3, 30, 32
Economic environment of QBU
—In general 60:5
—Facts and circumstances determination of economic environment 60:6
—Integral extension rule for certain QBU country economic environments 60:6
—Local currency activities volume 60:7
—Sufficient commitment rule for foreign country economic environments 60:5
Effective date of §988 ... 60:26
Election by QBU to use U.S. dollar as functional currency 60:2, 8
Foreign branch taxable income or loss determination
—In general 60:3, 28
—Net worth method 60:27, 29
—Prior law 60:27
—Profit and loss method 60:28, 29
—Purpose of foreign currency translation provisions 60:28
—Specific transactions method 60:28
Foreign tax credit
—Prior law 60:33
—Translation of foreign tax payment into U.S. dollars for determination of deemed-paid credit 60:3, 27, 34
Functional currency 60:1, 4, 7
Historical background 60:1, 3
Nonfunctional currency transactions, see subhead: Section 988 transactions
Original issue discount and bond premiums exceptions to functional currency rules 60:9, 20
Property treatment of foreign currency 60:9
Purpose of foreign currency rules 60:4
Qualified business units (QBU) 60:1, 4, 6
Regulations to be issued 60:3
Remittances 60:3
Section 988 hedging transactions
—In general 60:2, 11, 25
—Corn Products doctrine 60:12, 13
—Definition 60:25
—Election to treat foreign currency gain on certain transactions as capital gain 60:13
—Fully hedged transactions 60:25
—Partial hedges 60:26
Section 988 transactions
—In general 60:2, 10
—Accounts payable and accounts receivable 60:16
—Booking date 60:11
—Character of gain or loss 60:12, 19, 21, 23, 24
—Currency dispositions 60:15
—Currency swaps 60:24
—Debt instrument repayments 60:16, 18, 19
—Exchange gains and losses 60:10
—Foreign currency loans 60:21
—Forward contracts, futures contracts and option contracts 60:22, 26
—Interest income or expense characterization of ordinary gains and losses 60:13
—Nonfunctional currency dispositions 60:11
—Options 60:23
—Original issue discount 60:20, 22
—Realization of gain or loss 60:11, 18, 23
—Related party transaction source rules 60:15
—Source of income 60:14, 19, 22, 24
—Stated interest 60:19, 22
—Withholding taxes on currency swap transactions 60:25
Separate reporting of exchange gains or losses from gains or losses from underlying transaction 60:1, 9, 12
Straddle positions 26:2; 60:3, 18

Foreign governments
Income taxation
—In general 71:4
—Commercial income 71:5
—Controlled commercial entities 71:5
—Exempt income 71:5
—Prior law 71:4

Foreign investment companies
In general 64:2
Definition 64:2
Gain on sale or exchange of stock 64:2
Passive foreign investment companies, see Passive foreign investment companies

Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)
In general 72:6
Agent liability 72:7
Foreign corporation election of domestic corporation treatment 72:7
Notice requirements 72:7
Penalties 72:8
TRA 1984 amendments 72:6
U.S. real property holding corporations 72:8

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Foreign Investment—Contd.
Withholding exemptions 72:7
Withholding tax
—Certain domestic partnerships, trusts and estates 72:7, 8
—Payment of tax 72:8

Foreign personal holding companies
In general 64:1; 72:9
Definition 63:8
Income
—Commodities transactions gains 63:2
—Dividends 63:2
—Foreign currency gains and losses 63:2
—Income equivalent to interest 63:2
—Interest 63:2
—Passive income included 63:1
—Same country dividend and interest exception 72:9
—Undistributed personal holding company income computation, income included 71:2
Related persons 72:9
Stock ownership test
—In general 71:1
—Effective dates, TRA 1986 amendments 71:2
—Prior law 71:1
—Stock held through foreign entity, tracing rule 72:10
TRA 1984 amendments 72:9

Foreign sales corporations
Corporate preference reductions 72:14
Debt-financed portfolio stock dividends received from, nonapplication of §246A dividends-received deduction limitation 34:2
Exchange of information requirements 72:14
Principal bank account 72:15
U.S. possessions taxation 72:15

Foreign tax credit
In general 59:1, 11
Alternative minimum tax foreign tax credit 32:40; 33:45
Carrybacks to pre-1987 years, limitations 59:22
Deemed paid credit
—In general 59:2, 17
—Accounting periods of less than one year 59:18
—Amendments to §960 ... 59:18
—"Chain deficit rule" repeal 59:19
—Coordination of pooling rules and separate limitations categories 59:19
—Distributions from pre-1987 earnings 59:18
—Foreign currency tax payment translation into U.S. dollars 60:3, 27, 34
—Pooling post-1986 earnings and profits 59:17, 18; 60:32, 33
—Post-1986 acquisitions 59:18
—Prior law 59:16
—Regulatory authority 59:18
Dividends from noncontrolled §902 corporations 59:6
Dividends-received deduction, coordination with 67:3
Effective dates, TRA 1986 amendments 59:11, 18, 20; 72:3
Export financing interest 59:5, 12
Financial services income
—In general 59:6, 14
—Predominantly engaged test 59:14
Foreign currency translation 60:3, 27, 32, 33, 34
Foreign losses
—In general 59:20
—Allocation and recharacterization rules 59:20, 21
—Definitions 59:20
—Examples 59:20, 21
—Recapture rule 59:3
High withholding tax interest
—In general 59:5, 12
—High withholding tax defined 59:13
—Noncontrolled §902 corporations 59:13
—Transition rule 59:13
High-taxed income 59:5, 12
Limitation
—In general 59:1
—Separate limitations categories, see subhead Separate limitations categories
Look-through rules
—In general 59:7, 14
—Dividends 59:15
—Examples 59:9
—Interest, rents, and royalties 59:15
Oil and gas extraction income 59:5
Passive income
—In general 59:4, 11
—Definition 59:4
—Exceptions 59:5, 12
Payments by designated payor corporation recharacterized as interest
—In general 72:2
—Amounts recharacterized as separate limitation interest 72:3
—De minimis rule limitation 72:3
—Designated payor corporation definition clarified 72:3
—Effective dates, TRA 1986 amendments 72:3
—TRA 1984 amendments 72:2
Prior law 15:1
Regulatory authority 59:10
Related persons 59:7
Separate limitations categories
—In general 59:4
—Background and development 59:2, 3
—Coordination with pooling rules 59:19
—Dividends from noncontrolled §902 corporations 59:6
—Financial services income 59:6
—High withholding tax interest 59:5
—Passive income 59:4, 11
—Related person factoring income rules, amounts treated as interest 72:4
—Shipping income 59:6
Shipping income 59:6
Source rule 59:10, 16
Taxes used as subsidies 59:22
Transitional rules for pre-1987 taxable years 59:7

Forfeiture of nonvested benefits
Defined benefit plans 54:29
Defined contribution plans 54:29
Money purchase pension plans 54:29, 30, 31

Foster care payments
Extension of excludable payments 2:5

Foundations, private
Estimated tax installment payments due on net investment income excise tax and unrelated business income tax 45:2; 50:4
Self-dealing excise tax
—Below-market interest rate loans, self-dealing definition not to take into account 31:7
—Government official definition 50:5

401(k) plans
In general 54:18
Actual deferral percentages 54:18, 19, 23
Benefits not contingent on election to defer 54:20, 28
Cost of living adjustments 54:19
Distribution of excess deferrals 54:19, 22
Distribution restrictions 54:20
Effective dates, TRA 1986 amendments 54:21, 22, 28
Elective deferrals limitation 54:19, 21
Employer contributions 54:19, 20, 21
Excess aggregate contribution definition 54:24
Excess contribution definition 54:24
Excess contribution distribution before end of following plan year 54:24
Excess elective deferrals 54:19, 20, 20, 21, 24
Excise tax on excess elective deferrals 54:20, 24
Exempt organization ineligibility 54:21, 27
Government entity ineligibility and exceptions 54:21, 27, 28
Highly compensated employees 54:20, 23
Master and prototype plans 54:36
Matching contributions 54:20, 21
Nondiscrimination rules 54:19, 23
Participation standards 54:20, 27
Prior law 54:18
Regulations to be issued 54:36
Thrift plans, relationship between 401(m) and 401(k) 54:26
Withdrawal restrictions 54:12, 13, 27

401(m) plans
See
—Thrift plans

Fraud
See
—Civil tax penalties

Fraudulent transactions
See
—Tax motivated transactions

Freight forwarder operating authorities
See
—Bus and freight forwarder operating authorities

Fringe benefits
See also
—Cafeteria plans
—Specific types of fringe benefits
In general 51:1
Applicable exclusion 44:17
Automobile product testing as working condition fringe benefit 51:4
Class of employees entitled to employee discounts 51:5
Customers definition 51:5
Dependent children definition 51:5
Employee discount definition 51:5
Excise tax on certain fringe benefits 51:5
Excludable housing allowances, effect on mortgage interest and property tax deductions 9:2
Free telephone service for pre-divestiture retirees of Bell System 51:5
Information return requirements for specified fringe benefit plans 44:17
Line of business requirement for employee discounts 51:4
Military fringe benefits 51:3
Public transportation commuting expenses programs 51:5

Functional currency
See
—Foreign currency transactions and translation

Funding of qualified plans
Minimum funding standard 54:37

Futures contracts
See
—Commodity futures contracts

G

Gains or losses
See also
—Built-in gains
—Capital gains and losses
Alternative minimum tax, AMTI computation 32:26
Alternative tax for corporations, AMTI computation 33:8, 24
Appreciated property distributions 37:1
Complete liquidation distributions of property by corporation 36:1
Distributions, corporate 37:3
Distributions in kind, election by executor or trustee 47:3
Foreign currency transactions 60:1, 2, 9
Installment obligation dispositions 18:1, 3
Market discount bond dispositions 31:6
Nongovernment obligation disposition gain 31:4
Real Estate Mortgage Investment Conduit (REMIC) 42:5
Reorganizations, corporate 38:10
Sales or exchanges in connection with corporate liquidations, §337 ... 36:2
Subsidiary liquidation distributions 36:3
Wetland and cropland dispositions
—Converted wetland 28:2
—Effective dates, TRA 1986 amendments 28:2
—Highly erodible cropland 28:2
—Long-term capital loss treatment 28:2
—Ordinary income treatment 28:2
—Prior law 28:1

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

General business credit
See also
—Specific types of credits
Alternative minimum tax 15:7, 8
Effective date, TRA 1986 amendments 15:2
ESOP tax credit 15:3
Low-income housing credit 15:2, 3
Passive losses 15:6
Prior law 15:2
Research and development tax credit 15:3
Tax liability limitation, 1986 ... 15:3

General Utilities doctrine
See also
—Built-in gains
—Distributions of property in liquidation
—Installment obligations
Effective date, TRA 1986 amendments 36:5
Regulatory authority of IRS to carry out purpose of doctrine repeal 36:2
Repeal 18:7; 36:1; 38:1

Generation-skipping transfer tax
In general 48:2, 4
$1,000,000 exemption
—In general 48:9
—Allocation of exemption 48:9, 10
—Coordination with $2,000,000 exemption 48:15
—Inter vivos use, planning considerations 48:12
—Planning considerations 48:9
—Qualified terminable interest property 48:9
—Use of separate trusts where assets exceed $1,000,000 ... 48:14
$2,000,000 per grandchild direct skip exemptions
—In general 48:10
—Coordination with $1,000,000 exemption 48:15
—Inter vivos use, planning considerations 48:13
—Testamentary use, planning considerations 48:15
Administration 48:18
Alternative minimum tax itemized deductions 32:22
Basis adjustments 48:18
Credit for state taxes 48:17
Definitions
—Direct skips 48:7
—Generation-skipping transfer 48:5
—Interest 48:5
—Non-skip-person 48:6
—Skip-person 48:6
—Taxable distributions 48:6
—Taxable terminations 48:6
—Transferor 48:5
—Trust 48:5
—Trustee 48:5
Disclaimers 48:17
Effective dates, TRA 1986 amendments
—In general 48:18
—Planning considerations 48:19
Election of first spouse to be treated as transferor with respect to QTIP trust 48:15
Exemptions
—$1,000,000 exemption 48:9, 12
—$2,000,000 direct skip exemptions 48:10
—Gift tax exclusions 48:8
—Planning for full use of both spouses' exemption 48:12
—Predeceased child exclusion 48:8, 14
Extension of time to pay 48:18
Federal gift tax exclusion, planning considerations 48:12
Generation assignments 48:17
Inclusion ratio 48:11
Income 48:17
Legislative history 48:2
—House committee report 48:3
—Methods for avoiding or minimizing pre-TRA 1986 GSTT 48:3
—Treasury I reform proposals 48:3
Liability for tax 48:8, 18
Multiple skips 48:7
Planning considerations
—In general 48:12
—Assets in excess of exemptions 48:16
—Effective dates, TRA 1986 amendments 48:19
—Inter vivos use of exemptions and exclusions 48:12
—Testamentary use of exemptions and exclusions 48:14
Prior law 48:1
Redemptions of stock to pay tax 48:18
Return filing requirements 48:18
Table summarizing 1986 TRA GSTT provisions 48:21
Taxable amount determination
—In general 48:7, 11
—Direct skips 48:8
—Exemptions 48:8
—Inclusion ratio 48:11
—Taxable distributions 48:7
—Taxable terminations 48:8
Trustee liability 48:18

Gift tax
Deduction for conservation easement contribution 49:2

Gifts
See also
—Charitable contributions
Employer gifts to employee, employee inclusion in gross income 2:3

Golden parachutes
In general 51:11
Affiliated groups of corporations 51:12, 13
Effective dates, TRA 1986 amendments 51:14
Exception for payments made by certain small business companies and corporations with not readily tradable stock 51:12
Excluded amounts 51:14
Highly compensated individual number limitation 51:12, 14
Independent contractors 51:14
Qualified plan distributions 51:12, 13
Reduction of excess payments to extent of reasonable compensation 51:12, 13
Securities law violation payments 51:14

Government plans
See also
—State and local government plans
401(k) plan ineligibility and exceptions 54:21, 27, 28
Sec. 415 limitations 54:15

Grantor trusts
Clifford trusts 47:2
Inter vivos charitable lead trusts 47:2
Power or interest held by spouse 47:2
Spousal remainder trusts 47:2

Greenmail
Capitalization of stock redemption expenses 34:2

Gross income
See also
—Exclusions from gross income
—Taxable income
Alimony payments 1:3
Business gifts from employer to employee 2:3
Capital gains deduction repeal 2:4; 34:3
Contributions in aid of construction of regulated public utilities and exceptions 1:1, 2; 34:1
Excess benefit received by employee from plan discriminating in favor of highly compensated employees 53:6
Interest on frozen deposits, inclusion in gross income 74:6
Interest on installment payments of life insurance proceeds paid to surviving spouse, repeal of former §101(d)(1)(B) exclusion 2:3
Scholarships and fellowship grants representing payments for services 2:2
Short-term obligation discount 31:4
Tax benefit items 2:5
Unemployment compensation benefits 1:1

Group health plans
See
—Accident and health benefits

Group legal services plans
See
—Legal services plans

Group-term life insurance
See also
—Life insurance
—Nondiscrimination rules for certain statutory employee benefit plans
Comparable successor plans 75:28
Cost of discriminatory plans 75:27
Discrimination in favor of key employees 51:15
Effective date, TRA 1984, clarification of 75:27
Effective date, TRA 1986 amendments 51:15
Employer-provided benefit determination and adjustments 53:8
Former employees 51:15; 75:27
Information return requirements for specified fringe benefit plans 44:17
Key employees 51:15; 75:27
Nondiscrimination rules 53:1
Prior law 53:1, 3
Restricted property, §83 application to value of nonforfeitable insurance 51:15; 75:27
Sec. 79, technical corrections to 51:14, 15

Guam
In general 70:1
Amounts covered into Guam treasury by U.S. 70:8
Corporate withholding tax exemption
—Anti-abuse provisions 70:5
—Prior law 70:4
Corporations 70:4
Effective date, TRA 1986 amendments 70:3
Grant of authority to pass own tax laws 70:2
Interest on U.S. obligations paid to Guamanian banks 70:1
"Mirror" tax system 70:1, 2
Possession-source income, exclusion from gross income 70:3

H

Hardship withdrawals
See
—Distributions, pension & profit-sharing plans

Hazardous waste
Exempt facility bonds for qualified hazardous waste facilities 30:7

Health insurance
See also
—Accident and health benefits
—Disability benefits
—Medical expenses
Self-employed individuals, 25 percent deduction of expenses 51:2

Hedging transactions
See also
—Foreign currency transactions and translation
—Section 1256 contracts
—Straddles
Foreign currency, §988 hedging transactions 60:2, 25

Holding period
Collapsible corporations, ordinary income treatment 38:12
Dividends-received deduction 34:2
Extraordinary dividends 37:3
Passive foreign investment company stock 64:6

Household and dependent care credit
Prior law 15:1

Housing
See also
—Principal residence
Excludable housing allowances 9:2
Low-income housing
—Credit, see Low-income housing credit
—Depreciation 8:16

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

I

Identification numbers
See
—Tax shelters
—Taxpayer identification numbers (TINs)

Imports
Valuation 68:8

Imputed interest
See also
—Original issue discount
Debt instruments' issue price as their stated redemption price at maturity 31:7
Land dispositions between related parties 31:6
Transitional rules for TRA 1984 amendments 31:7

Incentive stock options
In general 51:6
Alternative minimum tax, AMTI computation 32:33
Limitation on amount of ISOs for individual employees 51:7
Nonstatutory stock option taxation comparison 51:7
Sequential exercise rule repeal 51:6
Tax preferences 32:33; 51:7
Tax rate reduction consequences 51:7
Valuation of stock 51:7

Income
See also
—Exclusions from gross income
—Gross income
—Related person factoring income
—Source of income and deductions rules
—Taxable income
—Unearned income
—Unrelated business taxable income
Effectively connected income 71:5
Financial services income 59:6, 14
Foreign base company services income 72:11
Foreign governments 71:4, 4
Foreign oil and gas extraction income 59:5
International organizations 71:4, 5
Passive income 64:3
Possessions-source income 70:3
Subpart F income 63:2

Income averaging
Prior law 10:6
Repeal 10:6

Independent contractors
Real estate investment trusts, furnishing of customary services for tenants 41:4

Individual retirement arrangements
See also
—Distributions, pension & profit-sharing plans
—Rollovers
In general 55:2
Amount of contribution
—In general 55:3
—Nondeductible contributions 55:3
Distributions
—In general 55:4
—Mandatory 55:4
—Premature withdrawals 55:4; 57:13, 15
—Taxation 57:6
—Timing of distributions 57:15
Effective dates, TRA 1986 amendments 55:2
Eligibility requirements 55:2, 3
Legislative history 55:1
Planning considerations 55:4
Premature withdrawals
—Miscellaneous exceptions to penalty tax not applicable to IRAs 57:15
—Qualified plan penalty tax replacement of §408(f) early distribution penalty 57:13
Prior law 55:1
Rollovers from qualified plans 57:7, 11

Industrial development bonds
See
—Private activity bonds
—Qualified small issue bonds

Information returns
See also
—Returns
Brokers 44:10, 10
Cooperative housing corporations 44:14
Dividends, patronage dividends, and interest, §6724 special rules 44:6
Estates and trusts
—Fiduciary report to beneficiaries 44:10
—Fiduciary report to nominees of beneficiaries 44:13
Failure to file penalty, §6721 replacement of §6652 ... 44:3, 5
Failure to include correct information, §6723 penalty 44:6
Failure to include interest or dividends reported on information return in income, §6653(g) penalty 44:4, 8
Federal agency contracts 44:11
Foreign-owned corporations
—Corporations required to file 69:1, 2
—Information required 69:1, 2
—"Related persons" 69:1, 2
Fringe benefit plans 44:17
Mortgage interest received 44:10
Partners and nominees of partners 44:10, 13
Real estate transactions 44:11
Resident aliens living abroad 69:2, 3
Royalties 44:10, 12
Tax-exempt bonds 30:12
Tax-exempt interest 44:10, 13
U.S. citizens resident abroad 69:2, 3

Installment obligations
Allocable installment indebtedness 18:3
Applicable installment obligations 18:3
Gain or loss upon disposition 18:1, 3, 7
Outstanding indebtedness 18:4
Pledges 18:2
Sales or exchanges in connection with corporate liquidations, §337 ... 18:7
Subsidiary liquidations 18:7

Installment sales
In general 18:1
Affiliated groups and related parties 18:4
Alternative minimum tax, AMTI computation 18:5; 32:18
Alternative tax for corporations, AMTI computation 33:8, 21
Builder bonds 18:1
Effective dates, TRA 1986 amendments 18:6, 7
Exceptions to proportionate disallowance rule 18:5
Prior law 18:1
Proportionate disallowance rule for disposition of certain installment obligations 18:2
Publicly-traded property sales ineligibility 18:6, 7
Real estate issues 76:4
Related party transactions 25:2
Revolving credit plans ineligibility 18:6, 7
Sales or exchanges in connection with corporate liquidations, §337 ... 18:7, 8
Timeshare interests and unimproved residential lots 18:5
Unrealized receivables and inventory items, §751 property 18:8

Insurance
See also
—Group-term life insurance
—Life insurance
Excise tax on policies 71:8
Study of reinsurance industry 71:9

Insurance companies
See also
—Captive insurance companies
—Life insurance companies
—Property and casualty insurance companies
Alternative tax for corporations, AMTI computation 33:25, 31
Blue Cross/Blue Shield organizations
—In general 75:11
—Material change in operations 75:12
—Other organizations eligible for special provisions 75:12
—Special basis adjustment 75:11
—Special deduction 75:11
—Unearned premium reserve exemption 75:11
Development of tax treatment 75:1
Exempt organizations providing commercial-type insurance
—In general 75:10
—Blue Cross/Blue Shield organizations 75:11
—Effective dates, TRA 1986 amendments 75:12
—Excluded organizations 75:12, 13
—Treasury Dept. study 75:13
President's reform proposals 75:1
TRA 1986 amendments 75:2

Intangible drilling costs
Alternative minimum tax, AMTI computation 32:31
Alternative tax for corporations, AMTI computation 33:6, 9, 36
Election to expense costs by domestic producers 7:2
Foreign IDC expenditure amortization or depletion alternatives 7:3
Foreign IDC treatment, exceptions to 7:3
Percentage reduction of integrated domestic producers' costs eligible for expensing 7:2
Tax preferences 32:31; 33:6, 9, 36

Intangible property
Foreign corporation transfers under §367 ... 66:3; 68:3
Possessions of U.S., transfers to 66:3; 68:4
Possessions tax credit intangible property income 66:4, 5, 6, 7
Sales, source of income 61:2, 5, 8, 12, 18
Transfer pricing allocations under §482 ... 68:2, 4, 5

Integration of qualified plans
Defined benefit excess plans 54:9, 11
Defined benefit offset plans 54:10, 11
Defined contribution plans 54:9
Effective dates, TRA 1986 amendments 54:11
Multiple integrated plans 54:11
Nondiscrimination rules 54:11

Intentional disregard of rules and regulations
See
—Civil tax penalties

Intercompany transfer pricing
See
—Allocations under §482

Interest
See also
—Applicable Federal Rate (AFR)
—Imputed interest
—Investment interest
—Original issue discount
—Payee statements
—Tax-exempt interest
Abatement of interest imposed on underpayment of tax or installment payment of tax due to IRS error or untimely performance of ministerial act 44:16
Accrued benefits, present value determination 54:28, 30
Accumulated earnings tax, timing of imposition of interest on underpayment of tax 44:14, 15
Amortizable bond premium 5:8; 31:1, 2
Branch level interest tax
Capitalization of interest 5:8; 8:9
Compounding of interest on deficiencies, suspension of compounding if waiver on restrictions on assessment filed 44:14, 16
Deduction for interest paid by individuals, see subhead: Personal interest
Foreign tax credit look-through rules 59:7, 15
Frozen deposits, inclusion in gross income 74:6
Interest income
—50 percent exclusion of interest paid on employer securities acquisition loans received by regulated investment companies 52:3
—Economic accrual of interest 31:1
—Failure to file information returns and payee statements, §6724 special rules 44:6
—Failure to include interest reported on information return in income, §6653(g) penalty 44:4, 8

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Interest —Contd.
Interest income—Contd.
—Foreign currency ordinary gains and losses, treatment as interest income or expenses 60:13
—Information requirements 44:10, 13
—Installment payment of life insurance proceeds to surviving spouse 2:3
—Payee statement mailing requirements 44:13
—State or local bond interest exclusion from gross income 30:1
Life insurance contracts, denial of deduction for interest 5:8
Long-term contracts, interest allocations 20:4
Mandatory imposition of interest on underpayment of tax or installment payment of tax 44:14
Mortgage interest, see Mortgages
Overpayment of tax interest rate 44:14, 15
Personal interest
—In general 5:3; 75:25
—Alternative minimum tax itemized deductions 5:8; 32:22
—Cooperatives 5:7
—Deficiencies 5:7
—Definition 5:6; 32:21
—Effective date, TRA 1986 amendments 5:7
—Example 5:7
—Loans from qualified plans 57:16
—Qualified residence interest 5:6; 32:21; 57:17
—Real estate issues 76:5
—Secured debt requirements 5:6
Portfolio interest, withholding tax repeal 72:4, 5
Tax motivated transaction, interest on substantial underpayments attributable to 44:14, 16
Underpayment of tax interest rate 44:14, 15
U.S. obligations, interest paid to Guamanian banks 70:1

International organizations
Income taxation 71:4, 5

Inventory
Built-in gains 38:2
Dollar-value LIFO method of accounting 19:9; 21:1
Sales, source of income 61:7, 17, 19

Investment companies
See also
—Foreign investment companies
—Passive foreign investment companies
In general 40:1
50 percent exclusion of interest paid on employer securities acquisition loans received by RICs 52:3
Alternative tax for corporations
—ACE determination 33:34
—AMTI determination 33:31
Business development companies, qualification as RICs 40:5
Constructive receipt by shareholders of dividends declared in December 40:3
Excise tax on excess of required over actual distributions 40:2
Hedging transaction gains 40:4
Losses on sale of RIC stock 40:5
Notices to shareholders, deadline extension 40:6
Operating expenses 40:4
Permitted income defined 40:4
Preferential dividends 40:5
Series funds 40:3
Stock ownership recordkeeping requirements 40:5
"Third-party recordkeepers," status as 40:6

Investment interest
$10,000 deductible amount, elimination of 5:3
Alternative minimum tax itemized deductions 32:22
Amortizable bond premium 5:8
Definition 32:20
Limitations
—In general 5:4
—Definition 5:4
—Effective dates 5:5
—Net investment income defined 5:4; 32:20
—Persons to whom limitations apply 5:5
—Property held for investment defined 5:4
—Tracing problems 5:5
Passive loss coordination 5:3; 17:9
Prior law
—In general 5:1
—Definition 5:1
—Net investment income factor 5:2
—Sec. 163(b), persons subject to 5:2
—Special rules 5:2
—Tracing problems 5:1, 2
Real estate issues 76:4, 5

Investment tax credit
In general 11:1
Alternative tax for corporations 33:46
Basis reduction 11:5
Carryback election for steel companies and farmers 11:5
Credit carryfoward determination 11:5
Energy property, see Energy investment tax credit
General business credit 15:3
Listed property requirement
—In general 8:9, 10
—Computer or peripheral equipment exception 8:10
—"Listed property" definition 8:11; 73:6
Nonrecourse financing limitation 15:4
"Passenger automobile" definition 8:9, 10; 73:6
Percentage reductions of credit 11:4, 5
Placement in service requirement 11:4
Prior law 15:2
Real estate issues 76:7
Repeal 11:2
Sales and leasebacks of property 11:4
Transition property
—In general 11:2
—Binding contract rule 11:2
—Certain equipped buildings of plant facilities 11:3
—Property being constructed or reconstructed by taxpayer 11:3
—Property necessary to written supply or service contract or lease 11:3

Iron ore
See
—Coal and iron ore

Itemized deductions
See
—Deductions

J

Joint and survivor annuities
See also
—Qualified preretirement survivor annuities
Distributions 54:29; 57:9
Incidental benefits rule nonapplication 57:1
REA 1984 requirements, exceptions to 54:29, 30, 31, 32
Waiver by spouse in favor of designated beneficiary 57:9

K

Key employees
See also
—Top-heavy plans
Definition for §79 purposes 51:15; 75:27
Discrimination in favor of in group-term life insurance plan 51:15

L

Land clearing expenditures
Repeal of election to expense costs 7:1

Leased employees
See
—Employee leasing

Legal services plans
See also
—Nondiscrimination rules for certain statutory employee benefit plans
Cafeteria plan eligibility 51:2
Election to apply §89 nondiscrimination rules 53:4
Extension of time for exclusion from income 51:2
Information return requirements for specified fringe benefit plans 44:17
Nondiscrimination rules 53:1
Prior law 53:1, 3

Legislative history
See
—Specific subject headings

Levies
Amounts exempt from 46:4

Liabilities not incurred before economic performance
See
—Accounting

Libson Shops doctrine
Net operating loss carryforward limitations 35:2, 10

Life insurance
See also
—Group-term life insurance
Computational rule clarifications 75:26
Contracts failing to qualify as life insurance contracts for tax purposes 75:27
Contracts to cover burial expenses 75:27
Death benefits paid in installments 75:26
Deemed exchange rule
—In general 75:24
—Recapture ceilings 75:24
Definition 75:27
Exchanges under §1035 ... 75:31
Interest on loans, denial of deduction 5:8
Policy loans, interest deductibility limitation 75:25
"Premiums paid" 75:27
Single premium contracts 75:26
Welfare benefit funds, certain contracts excluded from fund definition 53:14

Life insurance companies
"50 largest stock companies" 75:20
Alternative minimum tax
—In general 75:14
—Acquisition expenses 75:18
—Inside buildup of life insurance and annuity contracts 75:18
—Small life insurance company deduction, nonapplicability 75:18
Certain mutual life insurers, transition rule 75:21
Equity base 75:20
Estimated taxes 75:20
Fresh start
—In general 75:22
—Clarification of TRA 1984 provisions 75:23
—Limitation 75:22
Life insurance salesperson status as employee for purposes of cafeteria plan requirements 51:4
Market discount bonds 75:13
Policyholders Surplus Account distributions 75:14
Prior law 75:13
Proration 75:21
Repeal of special life insurance company deduction 75:13
Reserves 75:19
Statement gain or loss from operations 75:20
Technical corrections, TRA 1984 and TEFRA 1982 ... 75:23
Variable contracts 75:21

Like-kind exchanges
Gain or loss recognition, allocation of purchase price of assets 27:2
Property identified as like-kind on 45th day 43:2
Tax avoidance expatriates 71:6

Limitations period
See
—Statute of limitations

Limitations to amount at risk
See
—At-risk limitation

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Limited partnerships
See also
—Partnerships
Passive activity losses
—Material participation determination 17:5
—Separate activity determination 17:3

Liquidations, corporate
See also
—Built-in gains
Complete liquidations, §331, see Complete liquidation distributions
Distributions of property in liquidation, §336, see Distributions of property in liquidation
Partial liquidations, see Partial liquidations
Pre-1989 liquidations of qualified corporations 36:5
Section 333 liquidations, see Section 333 liquidations
Section 337 liquidations, see Sales or exchanges in connection with corporate liquidations
Section 338, see Stock purchases treated as asset acquisitions, §338
Subsidiary liquidations, §332, see Subsidiary liquidations

Loans
See also
—Below-market interest rate loans
—Financing
—Loans to qualified plan participants
—Securities acquisition loans
At-risk limitation, extension to real property 16:3
Foreign currency loans 60:21
Life insurance contracts, denial of deduction for interest 5:8

Loans to qualified plan participants
In general 57:15
Amortization of repayments 57:16
Effective date, TRA 1986 amendments 57:17
Interest paid deduction 57:17
Maximum amount 57:16
Principal residence purchase exception to five year repayment period 57:17

Lodging
See
—Meals and lodging

Long-term contracts
Alternative minimum tax, AMTI computation 32:17
Alternative tax for corporations, AMTI computation 33:8, 20
Capitalization of interest, §263A 5:8
Completed contract method of accounting 20:1
Effective date, TRA 1986 amendments 20:4
Interest allocations 20:4
Percentage of completion-capitalized cost method of accounting 20:2
Real estate issues 76:9

Losses
See also
—At-risk limitation
—Capital gains and losses
—Casualty losses
—Gains or losses
—Net operating losses
—Passive activity losses and credits
Dual consolidated losses, restrictions
—In general 65:1, 2
—Effective dates, TRA 1986 amendments 65:3
—Exceptions 65:2
—Prior law 65:1
—Treaties, conflicts with 65:2
Foreign currency losses 60:10
Foreign losses 59:20
Liquidation distributions of property, limitations on recognition of losses 36:1
Real Estate Mortgage Investment Conduit (REMIC) 42:4, 10
Sale of RIC stock, disallowance of certain losses 40:5
Subsidiary liquidations of property to minority shareholders, nonrecognition of losses 36:3

Low and moderate income housing exempt facility bonds
See
—Exempt facility bonds

Low-income housing credit
In general 12:1
Amount of credit 12:2
At-risk limitation 12:7
Changes in ownership
—In general 12:7
—Partnerships 12:6
Effective dates, TRA 1986 amendments 12:8
General business credit, addition to 15:3
Minimum set-aside requirements
—In general 12:1
—Projects in New York City 12:2
—Qualified tenants 12:2
Passive loss rules
—In general 12:7; 15:6
—Transitional rules 12:7
Qualified basis
—In general 12:3
—Additions to qualified basis 12:5
—Federal grants, exclusion 12:4
—Purchase of existing buildings, qualification for credit 12:3, 4
—Rehabilitation expenditures 12:3, 4
—Residential rental property 12:4
—Time for determining basis 12:3
Real estate issues 76:7
Recapture of credit
—In general 12:5
—Amount recaptured 12:6
—Certification of compliance 12:6
—Correction of noncompliance 12:7
—Example 12:6
—Recapture events 12:6
State volume limitations 12:5

Lump sum distributions
See also
—Distributions, pension & profit-sharing plans
Excess distributions excise tax, lump sum distribution limits 57:18, 19
Pre-1974 capital gains treatment repeal 57:5
Premature withdrawal penalty tax exception for distributions pursuant to plan terminations 57:15
Recapture of amount by which taxes reduced due to lump sum distribution made prior to reemployment of plan participant 57:8
Ten year forward averaging method repeal 57:4

M

Market discount bonds
Original issue, bonds acquired at 31:5, 6
Partial principal payments 31:6
Prior law 31:5
Stripped bonds and coupons 31:6
Transferee's basis after exchange 31:6
Transferor's gain after exchange 31:6
Transfers to controlled corporations 31:5, 6

Matching contributions
See
—Contributions to qualified plans
—Thrift plans

Meals and lodging
80 percent limitation on deductible expenses and exceptions 6:1, 2
Qualified campus lodging exclusion from gross income 51:3
Skybox expenses restrictions 6:4
Substantiation requirements 6:1, 2
Taxpayer or employee of taxpayer presence at meal requirement 6:1, 3

Medical expenses
See also
—Deductions 32:20
Alternative minimum tax itemized deductions 32:22
Exception to qualified plan premature withdrawal penalty tax if distributions do not exceed employee's medical expense deduction 57:14

Medical reimbursement plans, self-insured
See also
—Accident and health benefits
Nondiscrimination rules 53:4
Prior law nondiscrimination rules 53:1

Merchant Marine construction funds
Qualified and nonqualified withdrawals from capital construction fund 29:1, 2
Time limit on fund deposits 29:1, 2

Military fringe benefits
Excludable housing allowances, effect on mortgage interest and property tax deductions 9:2
Exclusion from gross income 51:3

Mineral exploration and development expenditures
See also
—Coal and iron ore
—Depletion
—Intangible drilling costs
—Percentage depletion
Alternative minimum tax, AMTI computation 32:14
Alternative tax for corporations, AMTI computation 33:8, 17
Foreign expenditures amortization or depletion recovery alternatives 7:3
Percentage of costs required to be amortized by corporations 7:3
Tax preferences 33:6

Mineral interests and property
Recapture rules
—Depletion costs included 28:2
—Dispositions of portion of property 28:2
—Effective date 28:2
—Prior law 28:2

Minimum funding standard
See
—Funding of qualified plans

Minimum tax
See
—Alternative minimum tax
—Alternative tax for corporations

Minors
Unearned income of minors, see Unearned income

Miscellaneous credits
See also
—Clinical expenses testing tax credit
—Foreign tax credit
—Nonconventional fuels source tax credit
—Possessions corporation tax credit
—Research and development tax credit
Alternative minimum tax 15:7, 8

Money purchase pension plans
Defined benefit plan status for funding purposes 54:37
Forfeiture allocations 54:29, 30, 31

Mortgage certificate tax credit
Effective date, TRA 1986 amendments 15:2
Prior law 15:1

Mortgage revenue bonds
See also
—Private activity bonds
Advanced refunding prohibition 30:12
Change in use of property resulting in loss of exemption 30:12
Effective dates, TRA 1986 amendments 30:8
Federal guarantee prohibition 30:12
Income requirements 30:8
Information reporting requirements 30:12
Prior law 30:7
Proceeds use 30:7
Purchase price requirement 30:8
Qualified mortgage bonds 30:7
Qualified veterans mortgage bonds 30:8, 10
Registration requirements 30:12
Volume cap 30:9, 10

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Mortgage-backed securities
See
—Real Estate Mortgage Investment Conduit (REMIC)

Mortgages
See also
—Mortgage certificate tax credit
—Mortgage revenue bonds
Information returns for persons receiving mortgage interest 44:10
Shared appreciation mortgages held by REITs 41:4

N

Natural resources
See
—Coal and iron ore
—Depletion
—Mineral exploration and development expenditures
—Mineral interests and property
—Oil, gas, and geothermal property
—Percentage depletion
—Timber farming

Negligence or intentional disregard of rules and regulations
See
—Civil tax penalties

Net operating losses
Alternative minimum tax, AMTI computation 32:29
Alternative tax for corporations, AMTI computation 33:8, 34
Bad debts 74:2
Financial institutions
—Effective dates, TRA 1986 amendments 74:4
—Prior law 74:4
—Repeal of special carryover rules 74:4
—Special thrift institution carryforward 74:4
Limitations on carryforwards, §382
—In general 35:1, 3, 5
—Anti-abuse rules and regulations 35:10
—Attribution of stock ownership 35:5
—Bankruptcy proceedings 35:8
—Built-in losses and gains 35:8
—Continuity of business enterprise 35:5
—Effective date, TRA 1986 amendments 24:4; 35:10
—Libson Shops doctrine 35:2, 10
—Old loss corporation value reduction 35:7
—Ownership change 35:3
—Prior law 35:1
—Sec. 382 limitation 35:6
—Testing period for ownership change 35:5
—Thrift institutions 35:9
—TRA 1976 amendments, repeal of 35:10
Rental real estate allowance, treatment as NOL 17:9
Tax avoidance purpose, applicability of §269 to carryforwards 35:2, 10

Ninety-day letters
See
—Deficiency assessments

Nominees
See
—Beneficiaries
—Partnerships

Non-resident aliens
See also
—Resident aliens
In general 72:12
Election to be treated as resident alien 72:13
Estimated tax for individuals 45:3; 72:16

Nonconventional fuels source tax credit
Alternative minimum tax 15:8
Passive losses 15:6
Prior law 15:1

Nondiscrimination rules for certain statutory employee benefit plans
See also
—Accident and health benefits
—Cafeteria plans
—Dependent care assistance programs
—Educational assistance programs
—Group-term life insurance
—Legal services plans
—Medical reimbursement plans, self-insured
—Voluntary employees' beneficiary associations (VEBAs)
In general 53:2
401(k) plans 54:19, 23
Affiliated groups 53:12
Alternative test where health or group-term plans meet 80 percent coverage test 53:6
Amount includable in income 53:6
Average employer-provided benefit 53:5
Benefit requirements 53:5, 11
Civil tax penalty for failure to report information with respect to includable employee benefits 53:3
Compensation definition 54:1
Dependent care program benefits test 53:6
Dispositions and acquisitions 53:12; 54:5
Effective dates 53:3, 13
Election to aggregate different plans other than health plans for purposes of benefits test 53:6
Eligibility requirements 53:4, 5, 11
Excess benefit of highly compensated employee 53:7
Excludable employees 53:9; 54:4, 7
Former employees 53:12; 54:5
Group-term life insurance employer-provided benefit determination and adjustments 53:8
Health plans, special rules for application of benefit requirements 53:7
Highest permitted benefit determination 53:7
Highly compensated employee definition 53:8; 54:1, 20, 23, 36
Leased employees 54:34
Mandatory v. elective application of §89 ... 53:4
Matching contributions 54:25, 36
Prior law 53:1, 3
Regulations for integrated plans 54:36
Reporting requirements 53:4
Safe harbor benefits test 53:6
Self-employed persons 53:12
Separate lines of business of employer 53:10; 54:5, 36
Separate plan status for individual benefits and different levels of coverage 53:12; 54:7
Tax-deferred annuities 54:36; 56:2, 3
Thrift plans 54:20
Time for testing of eligibility and benefits 53:11
Valuation of coverage 53:12
Voluntary employees' beneficiary associations 53:2

Nonrecognition transactions
Built-in gains 38:2
Qualified securities sales to ESOP or certain worker cooperatives, §1042
—Employer securities percentage ownership requirements after sale 52:7
—Nonapplication of nonrecognition rule to gain of subchapter C corporation 52:7
—Qualified replacement property 52:7
—Recapture of gain on disposition of qualified replacement property 52:7

Nonrefundable business credits
See also
—Alcohol fuels tax credit
—ESOP tax credit
—General business credit
—Investment tax credit
—Targeted jobs tax credit
Alternative minimum tax 15:2, 3
Alternative tax for corporations 33:9
Passive losses 15:3

Nonrefundable personal credits
See also
—Elderly and permanently and totally disabled credit
—Household and dependent care credit
—Mortgage certificate tax credit
—Political contributions tax credit
—Residential energy tax credit
Alternative minimum tax 15:2, 3, 7; 32:42
Merchant Marine Capital Contribution fund, tax on nonqualified withdrawals 29:3

Nonstatutory stock options
See also
—Restricted property
Incentive stock options, comparison of 51:7

Northern Mariana Islands
In general 70:1
Amounts covered into Northern Mariana treasury by U.S. 70:8
Corporations
—In general 70:4
—Anti-abuse provisions 70:5
—Withholding tax exemption 70:4
Effective dates, TRA 1986 amendments 70:3
Grant of authority to pass own tax laws 70:2
"Mirror" tax system 70:1, 2
Possession-source income, exclusion from gross income 70:3

Notice of deficiency
See
—Deficiency assessments

Notice requirements
Real estate investment trusts capital gains dividend notices 41:5
Rollover options to plan participants 57:8

O

Oil, gas, and geothermal property
See also
—Depletion
—Intangible drilling costs
—Mineral exploration and development expenditures
—Percentage depletion
Passive activity status, exclusion from 17:14
Recapture rules
—Depletion costs included 28:2
—Disposition of portion of property 28:2
—Effective dates, TRA 1986 amendments 28:2
—Prior law 28:2

One-month liquidations
See
—Section 333 liquidations

Original issue discount
See also
—Bonds
—Imputed interest
Cash method obligors of short-term obligations 31:4
Fair market value issue price for debt instruments issued for property other than stock or securities regularly traded on established markets 31:7
Foreign currency transactions 60:9, 20, 22
Imputed interest rules coordination 31:7
Obligations held by foreign investors 72:6
Pre-TRA 1984 law 72:5
Real Estate Mortgage Investment Conduit (REMIC) interests 31:7; 42:9
TRA 1984 amendments 31:7; 72:5

Orphan drug tax credit
Extension of credit 14:4
Prior law 14:4

Overpayment of taxes
See
—Interest

Overstatement of pension liabilities, §6659(a)
See
—Civil tax penalties

P

Panama Canal Zone
U.S. citizens employed by Canal Zone Commission, taxation 71:7

Partial liquidations
See also
—Liquidations, corporate
Extraordinary dividends 37:4

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Participation standards
See also
—Nondiscrimination rules for certain statutory employee benefit plans
—Vesting standards
401(k) plans 54:20, 27
Aggregation and comparability of plans 54:4, 7
Average benefits test 54:3
Coverage of plan regulations to be issued 54:36
Effective dates, TRA 1986 amendments 54:6, 8
ESOPs 54:6
Excludable employees 53:9; 54:4, 7
Exemptions from minimum participation standards 54:7
Former employees 54:5
Leased employees 54:33, 34
Minimum participation standards 54:7
Nondiscrimination rules 54:11
PAYSOPs 52:4
Penalty tax upon failure to meet minimum coverage requirements 54:6
Percentage test 54:3
Ratio test 54:3
Separate lines of business of employer 53:10; 54:5
Separate plan status for individual benefits and different levels of coverage 53:12; 54:7
Statutory employee benefit plan eligibility requirements 53:4, 5
Tax-deferred annuities 56:2, 3, 4
Tuition expenses reductions programs 51:5

Partnerships
See also
—Distributions, partnerships
—Limited partnerships
—Unrealized receivables and inventory items, §751 property
At-risk limitation, extension to real property 16:2, 3
Depreciation 4:22
Disguised sales to partnerships or partners 43:1
Distributions, corporate 37:6
Distributions to foreign partners, withholding tax 69:3, 4
FIRPTA withholding requirements 72:7, 8
Information returns 44:10, 13
Nonliquidating distributions, limitation on gain recognized 43:1
Nonrecourse financing limitation 15:4
Related party transactions 25:2
Retroactive partnership allocations 43:1
Taxable year
—In general 23:2, 3
—52-53 week taxable year 23:4
—Business purpose exception 23:3
—Changes 23:5
—Effective dates, TRA 1986 amendments 23:4
—Prior law 23:1

Passive activities
In general 17:2
Change in status of activity 17:10
Losses and credits, see Passive activity losses and credits
Material participation determination
—In general 17:3
—Closely held C corporations 17:4
—Farming activity 17:5
—Limited partnerships 17:5
—Personal service corporations 17:4, 5
—Planning considerations 17:18
—Rental activities 17:6
Oil or gas property working interests 17:14
"Passive activity" 15:5; 32:26
Rental activities
—In general 17:6
—Definition 17:6
—Rental real estate allowance 17:7
—Revenue Rulings 17:6
Rental real estate allowance
—In general 17:7
—Active participation requirement 17:7
—Credits 17:10
—Estates 17:8
—Married individuals filing separately 17:8
—Phase-out 17:8
—Treatment as NOL 17:9
Separate activity determination
—In general 17:2
—Affiliated groups of corporations filing consolidated returns 17:2
—Limited partnerships 17:3

Passive activity losses and credits
In general 17:2
Alternative minimum tax, AMTI computation 32:26, 29
Alternative tax for corporations, AMTI computation 33:8, 25
Change in status of taxpayer 17:10
Credits
—In general 17:10
—Limitations 17:10
—Real estate rental allowance 17:10
Disposition of entire interest
—In general 17:11
—Capital loss limitation 17:11
—Change in nature of activity 17:13
—Election to adjust basis for credits 17:12
—Related party transactions 17:11
—Suspended losses in excess of potential gain 17:18
—Taxable transaction requirement 17:11
—Types of dispositions 17:12
Effective dates, TRA 1986 amendments 15:7; 17:15; 32:28
Exceptions 15:6; 32:27
Legislative history 17:1
Losses
—In general 15:5; 17:2, 8
—At-risk rules 17:9
—Carryforward of suspended losses 17:8
—Closely held C corporations 17:9
—Interest deductions 17:9
—Qualified residence interest 17:9
—Rental real estate allowance treatment as NOL 17:9
Nonrefundable business credits 15:3
Passive activities, see Passive activities
"Passive activity credits" 15:5; 32:27
"Passive activity losses" 15:5; 32:27
Phase-in rules 15:7; 17:15, 16; 32:28
Planning considerations 17:17, 18
Portfolio income exclusion
—In general 17:13
—Expenses 17:13
—Loans to pass-through entities 17:13
—Treasury authority to define 17:14
Real estate issues 17:16; 76:2
Suspended passive losses and credits 15:6; 17:8; 32:27
Taxpayers subject to limitations 15:5; 32:26
Transition rules
—In general 17:15
—Alternative minimum tax 17:16
—Amounts eligible for phase-in 17:16
—Carryforwards of losses and credits 17:16
—Pre-enactment interests 17:15
—Qualified low-income housing project losses 17:16
—Rental real estate allowance 17:16

Passive foreign investment companies
In general 64:3, 9
Attribution rules
—In general 64:8
—Corporations 64:8
—Partnerships, trusts, and estates 64:8
—Reattribution 64:8
—Separate classes of stock 64:9
Changing business exception 64:4
Definition 64:3
Disposition of stock
—In general 64:6
—Basis 64:6
—Deemed dispositions 64:6
—Holding period 64:6
Effective dates, TRA 1986 amendments 64:10
Excess distributions
—In general 64:5
—Allocation 64:5
—Deferred tax amount 64:5
Foreign personal holding company provisions applicability 64:9
Look-through rule 64:4
Newly-formed business exception 64:4
Qualified electing funds
—In general 64:7
—Deferral of tax by shareholder on undistributed earnings 64:7
—Distribution of amounts previously included in shareholder's income 64:7
—Election of status 64:7
Regulations needed 64:9
Sec. 1246 applicability 64:9
Shareholder taxation
—In general 64:4
—Disposition of stock 64:6
—Excess distributions 64:5
Subpart F applicability 64:9

Patronage dividends
Failure to file information returns and payee statement, §6724 special rules 44:6
Failure to include interest or dividends reported on information return in income, §6653(g) penalty 44:4, 8
Information reporting requirements 44:10, 13
Payee statement mailing requirements 44:13

Payee statements
Banks and collecting agents of foreign interest and dividends 44:13
Dividends, patronage dividends, and interest
—Failure to provide, §6724 special rules 44:6
—Mailing requirements 44:13
—Reporting requirements 44:10, 13
Failure to file furnish certain payee statements, §6722 replacement of §6678 ... 44:3, 5
Failure to include correct information, §6723 penalty 44:6
Failure to include interest or dividends reported on information return in income, §6653(g) penalty 44:4, 8
Royalties 44:12

Payment of taxes
See
—Civil tax penalties
—Deficiency assessments
—Extension of estate tax payment

PAYSOPs
See also
—ESOPs
Coverage requirements and effective date 52:4
Repeal of ESOP tax credit, §41 ... 52:4

Penalties
See also
—Civil tax penalties
Failure to comply with group health plan continued coverage requirements 53:16
Failure to meet minimum coverage requirements 54:6
Premature withdrawals from qualified plans 57:13

Pension Benefit Guaranty Corporation (PBGC)
Interest rate for determination of present value of accrued benefits 54:29, 30

Pension plans
See
—Distributions, pension & profit-sharing plans
—Employee benefit plans
—Specific types of plans

Percentage depletion
See also
—Depletion
Coal and iron ore percentage 7:4
Ineligibilty for lease bonuses, advance royalties, and other payments without regard to actual production 7:3

Percentage of completion-capitalized cost method of accounting
In general 20:2
40 percent PCM method 20:2, 3
Exceptions 20:3
Look-back method 20:3

Personal exemptions
1987 personal exemption 10:2
1988 personal exemption 10:2

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Personal exemptions—Contd.
1989 personal exemption 10:2
Dependency rules 10:3
Inflation adjustments 10:3
Phase-out of personal exemption 10:3
Prior law 10:2
Taxpayer identification number requirement for dependents five years old and older 44:12, 13

Personal holding companies
See also
—Foreign personal holding companies
Computer software royalties
—Effective dates, TRA 1986 amendments 38:8
—Exclusion 38:7
—Special rules 38:7
Prior law 38:6
Rates of tax 38:7

Personal property
Depreciable personal property sales, source of income 61:7, 12
Foreign currency 60:9
Sales, source of income 61:6, 11, 12.1000

Personal service corporations
Definition 17:5
Passive activity losses 15:5; 17:4
Taxable year
—In general 23:2, 3
—52-53 week taxable year 23:4
—Business purpose exception 23:3
—Changes 23:5
—Effective dates, TRA 1986 amendments 23:4
—"Personal service corporation" 23:4
—Prior law 23:2
—Related party rules 23:4

Political contributions tax credit
Prior law 14:5; 15:1
Repeal 14:5; 15:2

Pollution control facilities
Alternative minimum tax, AMTI computation 32:14, 36
Alternative tax for corporations, AMTI computation 33:8, 17
Tax preferences 32:36; 33:5

Possessions corporation tax credit
Alternative minimum tax, AMTI computation 33:9, 25
Amount of credit 66:2
Amounts received in U.S. 66:6, 8
Application to U.S. Virgin Islands 70:6
Cost sharing payments 66:6, 7
Effective date, TRA 1986 amendments 66:9; 68:5
Election of credit 66:1
Eligibility for credit 66:1
Gross income test 66:6, 9
Intangible property income 66:4, 6, 7
Intangible property transfers 68:4
Legislative history 68:4
Passive losses 15:6
Prior law 15:1; 66:1; 70:6
Profit split method 66:5, 6, 8
Qualified possession source investment income 66:2, 6, 8

Possessions corporations
Alternative tax for corporations, AMTI determination 33:31, 49

Possessions of United States
See also
—American Samoa
—Guam
—Northern Mariana Islands
—U.S. Virgin Islands
Allocations under §482 ... 66:2; 68:4
Controlled foreign corporations, treatment as 63:9
Definition 66:2
Foreign sales corporations, taxation of 72:15
Intangible property transfers 66:2, 3; 68:4

Powers of appointment
Grantor trusts 47:2

Preferred stock
Extraordinary dividends 37:3

Premature withdrawals from nonqualified plans
See
—Withdrawal restrictions of qualified plans

Premature withdrawals from qualified plans
See
—Withdrawal restrictions of qualified plans

Principal residence
Qualified plan loans to purchase or rehabilitate 57:17

Private activity bonds
See also
—Arbitrage bonds
In general 30:2
Advanced refunding prohibition 30:12
Arbitrage restrictions 30:11
Change in use of property resulting in loss of exemption 30:12
Disproportionate related private use test 30:3
Effective dates, TRA 1986 amendments 30:3, 11, 12, 13
Federal guarantee prohibition 30:12
Government owned facilities 30:2
Information reporting requirements 30:12
Issuance costs 30:10
Management contracts 30:2
Maturity limit 30:10
Operational relationship between governmental and private business interests 30:3
Output contracts 30:2
Prior law 30:2
Private loan bonds 30:3
Prohibited uses of proceeds 30:10
Public approval requirement 30:10
Qualified bonds 30:2
Registration requirements 30:12
Substantial user requirement 30:10
Trade or business and security interest tests 30:2, 3
Volume cap 30:9

Private foundations
See
—Foundations, private

Private loan bonds
See
—Private activity bonds

Prizes and awards
Certain scientific, educational, etc. awards donated to governmental unit or charitable organization 2:2
Employee achievement awards 2:3

Production of income expenses
Convention attendance expenses disallowance 6:1, 4

Profit-sharing plans
Forfeiture of nonvested benefits 54:29
Profit requirement 54:29, 30, 31
Survivor benefit requirements and exemptions 57:9, 11
Thrift plan contribution percentages 54:20, 25

Prohibited transactions
Real estate investment trusts 41:5
Real Estate Mortgage Investment Conduits (REMIC) 42:5, 12

Property
See
—Intangible property
—Personal property
—Real property
—Restricted property
—Specific types of property

Property and casualty insurance companies
Alternative minimum tax 75:10
Change in status as P/C insurance company 75:4
Fresh start 75:9
Loss reserve discounting
—In general 75:6
—Accident and health reserves 75:9
—Accident year 75:7
—Computation 75:6
—Effective date, TRA 1986 amendments 75:9
—Election by company to use own data to compute deduction 75:8
—Excluded amounts 75:6
—Interest rate 75:7
—International and reinsurance lines of business 75:8
—Line of business 75:7
—Loss payment pattern determination 75:7
—Undiscounted unpaid losses 75:6
Physicians' and surgeons' mutual protection and interindemnity arrangements or associations 75:10
Proration rule
—In general 75:5
—100 percent dividends 75:5
—Effective date 75:5
Protection against loss account repeal 75:10
Securities insurance 75:4
Small stock and mutual company exemption 75:10
Subchapter L restructuring 75:10
Title insurance 75:4
Title insurance discounting rules 75:8
Treasury Dept. studies 75:10
Unearned premiums
—Excess 1986 year-end balance 75:4
—Legislative history 75:3
—Limitation on deductibility 75:3
—Prior law 75:3

Public transportation expenses
Statutory fringe benefit exclusion from gross income for de minimus amounts 51:5

Public utilities
See
—Utilities

Puerto Rico
See
—Possessions corporation tax credit
—Possessions of United States

Puts and calls
ESOP and stock bonus plan distribution put options 52:5

Q

Qualified 501(c)(3) bonds
See also
—Private activity bonds
In general 30:9
Advanced refunding 30:12
Change in use of property resulting in loss of exemption 30:12
Federal guarantee prohibition 30:12
Information reporting requirements 30:12
Limitation on amount of outstanding bonds issued by §501(c)(3) organizations 30:9
Public approval requirement 30:10
Registration requirements 30:12

Qualified business units (QBUs)
See
—Foreign currency transactions and translation

Qualified domestic relations orders
Qualified plan distributions, application to 57:10, 14, 20

Qualified employee benefit plans
See
—Employee benefit plans
—Nondiscrimination rules for certain statutory employee benefit plans

Qualified mortgage bonds
See
—Mortgage revenue bonds

Qualified police and firefighter plans
Sec. 415 limitations 54:15

Qualified preretirement survivor annuities
See also
—Joint and survivor annuities
Accrued benefits 57:8

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Qualified preretirement—Contd.
Annuity starting date 57:8, 10
Beneficiaries other than spouses 57:8, 11
Defined contribution plans 57:8
Eligibility to receive benefits 57:8
Participant's right to waive preretirement survivor annuity 57:9
Surviving spouse's right to waive preretirement survivor annuity 57:9, 11

Qualified redevelopment bonds
See
—Redevelopment bonds

Qualified securities sales to ESOP or worker-owned cooperative
See
—Nonrecognition transactions

Qualified small issue bonds
See
—Small issue bonds

Qualified student loan bonds
See
—Student loan bonds

R

Railroads
Grading and tunnel bores, amortization repeal 7:4

Rates of taxes
Corporate taxpayers 34:3, 4; 75:13
Noncorporate taxpayers
—In general 10:1
—1987 tax rates 10:4
—1988 and later years tax rates 10:4
—Adjustments for inflation 10:5
—Phase-out of 15 percent bracket 10:5
—Prior law 10:4
—Real estate issues 76:1
Personal holding companies 38:7
Repeal of rate differential for corporate net capital gains 34:3
Trusts and estates 47:1

Real estate brokers
Information returns 44:11

Real estate investment trusts (REITs)
In general 41:1
Alternative tax for corporations
—ACE determination 33:34
—AMTI determination 33:31
Assessable §6697 penalty, elimination with respect to deficiency dividends 41:3
Calendar year accounting and distribution requirements 41:2
Capital gains and net operating losses 41:5
Capital gains dividend notices to shareholders 41:5
Customary services provided for tenants 41:4
Distribution requirements 41:4
Dividend distributions deemed 41:3
Earnings and profits 41:3
Effective dates, TRA 1986 amendments 41:5
Eligibility for REIT status election 41:3
Excise tax on failure to distribute income 41:3
Prior law 41:1
Prohibited transactions 41:5
Real estate issues 76:10
Rent or income based on net income or profits 41:4
Shared appreciation mortgages 41:4
Subsidiaries 41:3
Temporary investment of new capital 41:3

Real Estate Mortgage Investment Conduit (REMIC)
In general 42:2
Alternative tax for corporations
—ACE determination 33:34
—AMTI determination 33:31
Effective dates, TRA 1986 amendments 42:6, 14
Interests in real property 42:6
Permitted investments 42:2
Prohibited transactions
—In general 42:5, 12
—Nonpermitted assets 42:5
—Qualified liquidations 42:5
Qualified mortgage 42:2
Qualified replacement mortgage 42:2
Qualifying real property loan, §593 application 42:6
Qualifying requirements 42:2, 6, 7
Real estate issues 76:6
Regular interest holders 42:3
Regular interests
—In general 42:3, 8
—Original issue discount 31:7; 42:9
—Prepayment situation 42:9, 10
—Prepayment terms 42:9
Residual interest holders
—In general 42:4
—Excess accruals 42:4
—Nonrecognized gain/loss 42:5
—Procedural rules 42:5
—Taxation 42:4
—Wash sale rules 42:5
Residual interests
—In general 42:4, 10
—Amounts taken into account by interest holders 42:11
—Minimum inclusions in income 42:11, 12
—Net loss 42:4
—Other rules 42:12
—Pass-through rules 42:10
—REMIC taxable income and loss 42:10
—Taxable income 42:4
Taxable mortgage pools 42:6, 14
Technical amendments 42:6, 14
Terminations 42:13

Real property
See also
—Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)
At-risk limitation extension to real property, see At-risk limitation
Backup withholding on certain real estate transactions 44:11
Designated blighted areas 30:8
Imputed interest on land dispositions between related parties 31:6
Information returns requirements for real estate brokers 44:11
Timeshare interests and unimproved residential lots sold on installment method 18:5
TRA 1986 issues, overview 76:1

Reasonable compensation
Golden parachute payments 51:10, 11

Recordkeeping requirements
See
—Books and records

Redemptions of corporate stock
See also
—Distributions, corporate
—Dividends
—Liquidations, corporate
Capital gains deduction repeal 2:5
Capitalization of expenses incurred 34:2
Contribution to capital, nonapplicability of rule 38:12
Effective date, TRA 1986 amendments 38:12
Extraordinary dividends 37:4
Generation-skipping transfer tax 48:18
Stock purchase treated as asset acquisitions, §338 38:12

Redevelopment bonds
Designated blighted areas 30:8
Proceeds use 30:8

Registration of tax shelters
See
—Tax shelters

Regular tax
See
—Alternative minimum tax

Regulated investment companies
See
—Investment companies

Rehabilitation tax credit
In general 11:1, 6
"Alternative wall" test 11:6
Certified historic rehabilitations 11:8
Effective dates, TRA 1986 amendments 11:8
Exclusion of qualified property from revised ACRS rules 4:7
Noncertified historic structures 11:7
Nonrecourse financing limitation 15:3, 4
Passive losses 15:6
"Qualified rehabilitated building" requirement 11:6
"Qualified rehabilitation expenditures"
—In general 11:7
—Eligible property 11:7
—Excluded expenditures 11:8
Real estate issues 76:7
"Substantially rehabilitated" requirement 11:6

Related party transactions
In general 25:1
Disposition of entire interest in passive activity 17:11
Foreign currency transactions, source of income on §988 transactions 60:15
Imputed interest on land dispositions 31:6
Installment sales 18:4; 25:2
Liquidation distributions of property, limitations on recognition of losses 36:1
Partnerships 25:2
Sales of depreciable property 25:1

Related person factoring income
In general 72:3
Acquisition of trade or service receivables constituting U.S. property
—Exclusions of certain property 72:4
—Same country exception 72:4
—Separate limitation treatment of amounts characterized as interest 72:4
TRA 1984 amendments 72:4

Rents
Foreign tax credit look-through rules 59:7, 15
Real estate investment trusts 41:4

Reorganizations, corporate
Continuity of interest 74:5
Type C
—Boot 38:10
—Drop down of assets to controlled subsidiary 38:11
Type D
—Boot 38:10
—Effective date 74:5
—Financial institutions 74:5
Type G
—Financial institutions 74:5

Reporting and disclosure requirements of qualified plans
Civil tax penalty for failure to report information with respect to includable employee benefits 53:4
Discrimination by plan in favor of highly compensated employees 53:4
Failure by plan to meet writing, permanency, and exclusivity requirements 53:4

Research and development expenditures
Allocations, House reform proposals 61:11
Alternative minimum tax, AMTI computation 32:23

Research and development tax credit
In general 13:1
Activites for which credit not allowed 13:2
Carryforward, research and development credit 15:3
Effective date, TRA 1986 amendments 15:2, 3
Extension of credit to 1988 ... 13:1
General business credit, addition to 15:3
Limitations on credit 13:4
Passive losses 15:6
Prior law 15:1
Qualified research 13:2
Redesignation of §30 as §41... 13:1
University basic research credit 13:3

Reserves for bad debts
In general 8:5, 6

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Reserves for—Contd.
Commercial banks
—Effective date 74:2
—Financially troubled banks 74:2
—Large banks 74:1
—Net operating losses 74:2
—Prior law 74:1
—Recapture of existing reserves 74:2
—Tax preferences 33:5, 9, 39
Planning considerations 8:7
Prior law
—Computation of additions to reserves 8:5
—Dealer guarantees 8:5
Repeal for taxpayers other than specified financial institutions
—In general 8:6
—Dealer guarantees 8:6
—Transitional rules 8:6
—Utilities 8:6
Thrift institutions
—Deduction of reasonable additions 74:3
—Effective date, TRA 1986 amendments 74:3
—Preference items list 74:3
—Prior law 74:2
—Total assets test 74:3
Treasury study requirement 8:7

Resident aliens
See also
—Non-resident aliens
In general 72:12
Substantial presence test
—In general 72:12
—Election to be treated as U.S. resident during a calendar year 72:13
—Teachers and trainees exemption period 72:13
TRA 1984 amendments 72:12

Residential energy tax credit
Prior law 15:1

Restricted property
Group-term life insurance, §83 application to value of nonforfeitable insurance 51:15

Returns
See also
—Filing of returns
—Information returns
Alcohol, tobacco, and firearms, Treasury authority to set place for filing 73:6

Reversion of qualified plan assets to employer excise tax
In general 57:21
Amount of reversion subject to tax 57:21
Effective date 57:22
Exception for reversion on plan terminations transferred to ESOPs 52:4; 57:21
Prior law 57:20

Revolving credit plans
Installment sales method of accounting ineligibility 18:6, 7

Rollovers
See also
—Individual retirement arrangements
ESOP distributions to satisfy diversification requirements 57:7
Frozen deposits, extension of rollover period 57:7
Notice requirements to plan participants 57:8
Partial distributions from qualified plans to IRAs 57:7, 11
Post-death rollovers by surviving spouse to IRA 57:11, 20
Qualified plan distribution to IRA 57:7
Reemployment of plan participant, ineligibility of certain subsequent distributions for ten-year forward averaging or capital gains treatment 57:8
Self-employed taxpayer rollovers 57:11

Royalties
See also
—Allocations under §482
Backup withholding where payee TIN not supplied 44:12
Coal and iron ore, repeal of corporate capital gains treatment 7:4
Computer software royalties 38:7
Foreign tax credit look-through rules 59:7, 15
Information returns 44:10, 12
Payee statements 44:12

S

S corporations
See also
—Built-in gains
Accumulated adjustments accounts 43:2
Alternative tax for corporations
—ACE determination 33:34
—AMTI determination 33:31
Built-in gains of S corporations subject to C corporation tax 38:1
Effective dates, TRA 1986 amendments 23:4; 43:2
Election, coordination with election under TRA 1984 ... 26:5
Nonrecourse financing limitation 15:4
Qualified subchapter S trusts 43:2
Taxable year
—In general 23:2, 3
—52-53 week taxable year 23:4
—Business purpose exception 23:3
—Changes 23:5
—Effective dates, TRA 1986 amendments 23:4
—Prior law 23:2

Salary reduction arrangements
401(k) plans deferral limitation 54:19, 21
Federal Thrift Savings Fund contributions 54:32
Tax-deferred annuity contribution limitation 56:1, 2

Sales and leasebacks
ACRS transition rules 4:7

Sales or exchanges in connection with corporate liquidations, §337
Affiliated groups of corporations 38:9
Bulk sales of inventory 18:8
Installment obligations, repeal of General Utilities doctrine 18:7
Prior law 36:2
Recognition of gain or loss on disposition of property 36:2
Repeal of former §337 ... 36:2

Savings and loan associations
See also
—Banks
FSLIC payments
—Sec. 265(a)(1) deduction 74:6
—Sec. 597, repeal of 74:5
Net operating loss carryover rules 35:9; 74:4
Reorganizations
—Type D 74:5
—Type G 74:5
Reserves for bad debts 74:2
Rollover period suspension for frozen deposits in financially distressed instutitions 57:7
Tax-exempt interest 74:3

Scholarships
See also
—Fellowship grants
Gross income exclusion for qualified scholarships 2:1
Gross income inclusion of payments for services 2:2

Section 333 liquidations
Repeal of §333 liquidations 36:3

Section 351 transfers
See
—Transfers to controlled corporations

Section 382 limitation
See
—Net operating losses

Section 401(k) plans
See
—401(k) plans

Section 415 limitations
Annual compensation limit taken into account, see Contributions to qualified plans
Commercial pilot plans 54:16
Cost of living arrangements for defined benefit plans 54:16
Defined benefit plans 54:12, 13, 16
Defined contribution plans 54:12, 13
Effective dates, TRA 1986 amendments 54:18
Government and tax-exempt organization plans 54:15
Incorporation of limits by reference 54:17
Less than ten years participation defined benefit plan 54:14
Planning considerations 54:17
Qualified police and firefighter plans 54:15
Tax-deferred annuities 54:17
Transition rules 54:18

Section 482 allocations
See
—Allocations under §482

Section 751 property
See
—Unrealized receivables and inventory items, §751 property

Section 1256 contracts
Foreign currency contracts 60:22
Foreign currency denominated options 60:23

Section 501(c)(9) trusts
See
—Voluntary employees' beneficiary associations (VEBAs)

Securities
See also
—Bonds
—Debt instruments
—Greenmail
—Mortgage-backed securities
Golden parachute payments pursuant to violations of securities laws 51:14
Installment sales method of accounting ineligibility for sales of publicly-traded property 18:6, 7
Net unrealized appreciation of employer securities 57:7

Securities acquisition loans
50 percent exclusion of interest paid on employer securities acquisition loans received by regulated investment companies 52:3
Definition 52:3

Self-employed taxpayers
See also
—Self-Employment Contributions Act (SECA)
25 percent health insurance expenses deduction 51:2
Fishing boat crews 54:32
Statutory employee benefit plan participation 53:12

Self-Employment Contributions Act (SECA)
In general 58:1
Church and church organization exception 58:2, 3
Clergymen 58:2, 3
Effective date, TRA 1986 amendments 58:2

Sham transactions
See
—Tax motivated transactions

Shared appreciation mortgages
See
—Real estate investment trusts (REITs)

Short-term obligations
Cash method obligor deduction of OID 31:4
Definition 31:4
Election to accrue ratable share of acquisition discount on constant interest basis 31:4
Income inclusion rules 31:4
Nongovernment obligation disposition gain 31:4
Prior law 31:3
Ratable share computation 31:4
Stripped bonds or coupons 31:4

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Simplified employee pension plans
In general 55:5
Effective dates, TRA 1986 amendments 55:6
Elective employer contributions 55:5
Excess contributions by employee 55:6
Participation requirements 55:6
Sec. 401(k) plans compared 55:5
Social Security integration rules 55:6
Taxation of SEPs 55:6

Small issue bonds
Phase out 30:8
Substantially all of proceeds 30:8

Social Security
See
—Employment taxes
—Federal Insurance Contributions Act (FICA)
—Integration of qualified plans
—Self-Employment Contributions Act (SECA)

Soil and water conservation expenditures
Election to expense costs incurred pursuant to DOA-approved conservation plan 7:1
Repeal of deduction for expenditures for draining of wetlands, land preparation, and center pivot irrigation system installation 7:1

Source of income and deductions rules
In general 61:1, 16; 72:1
80-20 corporations
—In general 61:21; 72:1
—"Active foreign business income" test 61:21
—Dividends 61:22
—Effective date, TRA 1986 amendments 61:22
—Foreign corporations 61:22
—Interest received by related person 61:21
—Legislative history of TRA 1986 amendments 61:2, 5, 8, 12
—Withholding tax exemption for certain interest and dividends 61:22
Certain U.S. source interest paid to applicable CFC by an affiliated corporation 72:2
Deficiencies in pre-TRA 1986 rules 61:3
Depreciable personal property sales 61:7, 12
Foreign currency, §988 transactions 60:14, 15, 19, 22, 24
House tax reform proposals 61:6
Intangible property sales 61:5, 8, 12, 18
Interest and other expenses allocated to foreign source income
—In general 61:23
—Effective date, TRA 1986 amendments 61:24
—Legislative history of TRA 1986 amendments 61:3, 6, 9, 10, 15, 16
—Transitional rules 61:24
—Treasury regulatory authority 61:23
Inventory sales
—In general 61:7, 17
—Treasury Dept. study 61:19
Personal property sales
—In general 61:17
—Depreciable personal property 61:17
—Effective date, TRA 1986 amendments 61:19
—House tax reform bill 61:6
—Intangible property 61:18
—Losses 61:19
—Offices or fixed places of business 61:18
—President's tax reform proposals 61:4
—Senate tax reform bill 61:11
—Treasury Dept.'s tax reform proposals 61:2
President's reform proposals 61:3
Research and experimental expenditures 61:24
—Allocations, House reform proposals 61:11
Sales income 61:2, 4
Senate tax reform bill 61:11
Source maintenance rules, effect of treaty provisions on 72:2
Space and ocean activities
—In general 61:20
—Definition 61:20
—Effective date, TRA 1986 amendments 61:21
—International communications income 61:21
—Legislative history of TRA 1986 amendments 61:9, 14
Stock in foreign affiliated companies, sales 61:19
TRA 1984 amendments 72:1
TRA 1986 legislative history 61:1, 3, 6, 11
Transportation income
—In general 61:19
—Effective date, TRA 1986 amendments 61:20
—Exemption 61:20
—Gross basis tax 61:19
—Legislative history, TRA 1986 amendments 61:5, 9, 13
Treasury Dept. reform proposals 61:1

Special use real property valuation election
In general 49:1
Perfection of defective elections 49:1, 2

Specified fringe benefit plans
See
—Fringe benefits

Spouses
See
—Joint and survivor annuities
—Qualified preretirement survivor annuities

Standard deduction
1987 standard deduction 10:1
1988 and later years standard deduction 10:1
Dependency rules 10:3
Elderly and blind individuals 10:2
Inflation adjustments 10:3
Limitations for certain individuals 10:2
Prior law 10:1

State and local government bonds
See
—Tax-exempt bonds

State and local government plans
See also
—Government plans
—Tax-deferred annuities
Exempt organizations status as eligible employer under §457 ... 51:8
Required distributions under §401(a)(9), applicability to nonqualified §457 plans 51:8, 9; 57:2
Scope of §457 ... 51:9
Transfers between eligible deferred compensation plans 51:9

State and local taxes
Sales and transfer taxes
—Capitalization of expense requirement 8:9
—Repeal of deductibility 8:9; 9:2; 32:20

Statute of limitations
Additions to tax and additional amounts civil tax penalties 44:9
Suspension during disputes between IRS and third-party recordkeepers 46:1

Stock
See also
—Constructive stock ownership
—Preferred stock
Passive foreign investment company stock 64:6

Stock bonus plans
Put option distributions 52:5
Survivor benefit requirements and exemptions 57:9, 11

Stock options
See
—Incentive stock options
—Nonstatutory stock options

Stock purchases treated as asset acquisitions, §338
Affiliated groups of corporations 38:9
Basis of assets of target corporation after §338 election 36:4
Contribution of nondepreciable or nonamortizable loss assets before completion of qualified stock purchase 36:4
Effective dates, TRA 1986 amendments 36:5
Redemptions of corporate stock 38:12
Sale of stock of affiliated target corporation, allowance to treat sale as sale of target corporation's assets 36:5

Stock redemptions
See
—Redemptions of corporate stock

Straddles
Cash and carry straddles 26:5
Coordination of S corporation election and election under 1984 TRA §102(g) and (h) 26:5
"Deep-in-the-money options" 26:1
Definition 26:1
Dispositions of loss regulations, allowability of loss
—Glass v. Comr. (TC) 26:3, 4
—King v. Comr. (TC) 26:5
—London Options (TC) 26:3, 4
—Losses by commodities dealers 26:4, 5
—Miller v. Comr. (TC) 26:3
—Pre-TRA 1984 case law 26:2
—Securities trading firms 26:5
—Syndicate interests 26:5
—TRA 1984 §108, Temporary Regulations, application of 26:3
—TRA 1984 amendments 26:2
—TRA 1986 amendments 26:3, 5
Foreign currency transactions 26:2; 60:3, 18
"Qualified covered call" 26:1
Year-end rule 26:1

Stripped bonds
Gross income recognition by person stripping bond 31:4, 6

Structured settlement companies
Exclusion from gross income of physical injury or physical sickness liability assignments 2:4

Student loan bonds
Nexus with state issuing bond 30:8
Proceeds use 30:8
Volume cap 30:9

Subpart F income
See
—Controlled foreign corporations

Subsidiaries, corporate
Allocation of income between domestic parent and foreign subsidiary, see Allocations under §482
Debt-financed portfolio stock dividends received from wholly-owned foreign subsidiary, nonapplication of §246A dividends-received deduction limitation 34:2
Real estate investment trust subsidiaries 41:3

Subsidiary liquidations
Aggregation of stock ownership rules 36:3, 4
Appreciated property distributions to minority shareholders 36:3
Basis of property distributed to minority shareholders 36:3
Consolidated distributees as 80-percent distributees 36:3, 4
Foreign corporations as 80-percent distributees 36:3
Installment obligations 18:7
Nonrecognition of gain or loss on property distributions to 80-percent distributees 36:3
Nonrecognition of loss on property distributions to minority shareholders 36:3
Nontaxable liquidations, §332 ... 38:9
Sec. 336(e) election to treat certain stock sales, exchanges, or distributions and asset transfers 36:3
Tax-exempt entities as 80-percent distributees 36:3

Substantial understatement of tax liability, §6661
See
—Civil tax penalties

T

Targeted jobs tax credit
Effective date, TRA 1986 amendments 14:1
Extension of credit 14:1
General business credit 15:3
Maximum allowable credit 14:1
Non-summer employees 14:1
Passive losses 15:6
Prior law 14:1; 15:2
Qualified summer youth employees 14:1

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Tax avoidance purpose
Expatriate gain on sale or exchange of foreign property acquired in tax-free exchange for U.S. property 71:6
Net operating loss carryforward limitations 35:2, 10

Tax benefit rule
Alternative minimum tax 32:43
Alternative tax for corporations 33:49
Corporate add-on minimum tax 33:7
Taxpayers required to include tax benefit item in income 2:5

Tax Court
Interlocutory orders, appeals of 46:3
Jurisdiction, additions to tax 46:3
Periodic registration fee for practitioners 46:4

Tax credit ESOPs
See
—ESOPs
—PAYSOPs

Tax liens
Date of forfeiture of property 46:4
Land sales contracts 46:4
Listing and notice procedures 46:4
Sale of seized property 46:4

Tax motivated transactions
Interest imposed on substantial underpayments attributable to 44:14, 16
Sham or fraudulent transactions 44:17

Tax preference items
See also
—Alternative minimum tax
—Alternative tax for corporations
Accelerated Cost Recovery System (ACRS) deductions 32:36; 33:5, 6, 9, 42
Bad debt reserve deductions for financial institutions 33:5, 9, 39
Capital gains 33:6
Certified pollution control facilities 33:5
Charitable contributions of appreciated property 32:35; 33:9, 40
Circulation and research and experimental expenditures 33:6
Depletion 32:30; 33:6, 9, 35
Incentive stock options 32:33; 51:7
Intangible drilling and development costs 32:31; 33:6, 9, 36
Mining exploration and development costs 33:6
Pollution control facilities, amortization of 32:36
Tax-exempt interest 30:13; 32:34; 33:9, 40; 74:3

Tax rates
See
—Rates of taxes

Tax shelters
See also
—Passive activity losses and credits
Cash basis exception to economic performance requirement 24:3
Cash method accounting prohibition 22:2
Farming syndicates 24:3
Identification numbers, failure to furnish 44:2, 3
Investor lists, penalty for failure to maintain 44:2, 3
Real estate 76:1
Registration ratio determination 44:1, 2

Tax straddles
See
—Straddles

Tax treaties
Branch profits tax 62:3

Tax-deferred annuities
Aggregation of plans 56:4
Church plan exclusion from coverage and nondiscrimination requirements 56:3
Constructive receipt doctrine application repeal 56:4; 57:7
Coverage and nondiscrimination rules 56:2, 3
Elective deferrals 54:19; 56:3
Excess aggregate contribution definition 56:4
Excludable employes 56:4
Integration rules 56:4
Nonelective deferrals 56:3, 4
Prior law 56:1
Salary reduction arrangement contribution limitation 56:1, 2
Sec. 415 limitations 54:17
Withdrawal restrictions 57:12, 13

Tax-exempt bonds
See also
—Exempt facility bonds
—Mortgage revenue bonds
—Private activity bonds
—Tax-exempt interest
Alternative minimum tax, AMTI computation 32:34
Change in use of property resulting in loss of exemption 30:12
Effective dates, TRA 1986 amendments 30:3, 11, 12, 13.1000
Exclusions from gross income of state or local bond interest 30:1
Federal guarantee prohibition 30:12
Financial institutions, interest incurred by 74:3
Information reporting requirements 30:12
Qualified §501(c)(3) bonds 30:9
Real estate issues 76:8
Registration requirements 30:12
Volume cap 30:9
Volunteer fire department bonds 30:12

Tax-exempt interest
Alternative minimum tax, AMTI computation 30:13; 32:34; 74:3
Alternative tax for corporations, AMTI computation 33:9, 40
Financial institutions
—Allocation of interest expense 74:4
—Deduction for interest allocable to tax-exempt obligations 74:3
—Face amount certificate companies 74:4
—Prior law 74:3
—Qualified tax-exempt obligations 74:3
—Transition rules 74:4
Itemized statement of classes of exempt income 44:10, 13
State and local bond interest exclusion from gross income 30:1
Tax preferences 32:34; 33:9, 40
Taxpayers required to report on returns 44:13

Taxable income
See also
—Gross income
Foreign branch taxable income 60:3, 28
Foreign corporations 71:2
Real Estate Mortgage Investment Conduit (REMIC) 42:4, 10

Taxable year
In general 23:1
Alternative minimum tax 32:44
Alternative tax for corporations 33:49
DISC tax-year conformity requirement 72:16
Partnerships 23:1, 3, 4, 5
Personal service corporations 23:2, 3, 4, 5
S corporations 23:2, 3, 4, 5
Short taxable year 32:44; 33:49
Trusts 47:3

Taxes
See
—Accumulated earnings tax
—Branch profits tax
—Employment taxes
—Estate tax
—Estimated tax for corporations
—Estimated tax for individuals
—Excise taxes
—Federal Insurance Contributions Act (FICA)
—Federal Unemployment Tax Act (FUTA)
—Generation-skipping transfer tax
—Gift tax
—Self-Employment Contributions Act (SECA)
—State and local taxes
—Windfall profits tax
—Withholding taxes

Taxpayer identification numbers (TINs)
Dependents five years old and older 44:12, 13
Failure to supply identification numbers, §6676 penalty 44:6, 12
Federal agency contract information returns 44:12
IRS providing of TINs to certain taxpayers 44:10
Supplying on returns 44:10
Tax shelter identification numbers, penalty for failure to furnish 44:2, 3

Termination of qualified plans
ESOP distributions 52:4

Thrift institutions
See
—Savings and loan associations

Thrift plans
401(k) plans, relationship between 401(k) and 401(m) 54:26
Contribution percentages 54:20
Distribution of excess aggregate contributions before end of following plan year 54:26
Effective dates, TRA 1986 amendments 54:26
Excess aggregate contributions 54:20, 25; 56:4
Excise tax on excess aggregate contributions 54:20, 26
Federal Thrift Savings Fund contributions 54:32

Timber farming
Election to consider cutting as sale or exchange, transition rules 34:3

Tobacco
Returns, Treasury Dept. authority to set place for filing 73:6

Top-heavy plans
In general 54:29
Accrual of benefits 54:29, 30, 31
Defined benefit plans 54:29, 30, 31
Vesting standards 54:8

Trade or business expenses
See also
—Capital expenditures
Nondeductibility of stock redemption expenditures 34:2

Trademarks and trade names
Expenditures, repeal of 5 year amortization 8:4

Transfer pricing
See
—Allocations under §482

Transfers to controlled corporations
See also
—Capital contributions
Market discount bonds 31:5, 6

Travel expenses
See also
—Public transportation expenses
Charitable purposes travel expenses deduction restrictions 6:1, 4
Educational travel expenses deduction repeal 6:1, 4
Luxury water transportation expenses restrictions 6:1, 4
Production of income-related convention or seminar attendance expenses disallowance 6:1, 4

Trusts
See also
—Distributions, trusts
—Grantor trusts
Alternative minimum tax 32:43; 47:4
Distributions, corporate 37:6
Distributions in kind 47:3
Estimated income tax liability 45:2; 47:3
FIRPTA withholding requirements 72:8
Information returns
—Fiduciaries to beneficiaries 44:10
—Fiduciaries to nominees of beneficiaries 44:13
Miscellaneous itemized deductions 9:4
Multiple trusts 47:3

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Trusts —Contd.
Nonliquidating distributions, limitation on gain recognized 43:1
Passive activity losses 15:5
Rates of taxes 47:1, 2
Sec. 501(c)(18) trusts 55:6
Taxable years 47:3
Trustee fees 47:4

Tuition expenses
See
—Educational assistance programs
—Educational expenses

U

Underpayment of taxes
See
—Civil tax penalties

Unearned income
Unearned income of minors
—Effective dates, TRA 1986 amendments 10:7
—"Kiddie Tax" 10:6
—Planning considerations 10:7
—Prior law 10:6

Unemployment compensation
Inclusion in gross income 1:1

Unemployment tax
See
—Federal Unemployment Tax Act (FUTA)

Unrealized receivables and inventory items, §751 property
See also
—Partnerships
Distributions, corporate 37:6
Installment sales method reporting of gain 18:8

Unrelated business taxable income
Estimated tax installment payments by exempt organizations and private foundations 45:2; 50:4
Exceptions
—In general 50:3
—Low-cost articles, distribution 50:4
—Mailing lists sale or rental 50:3
—Trade show income 50:4
Real estate investment trusts, exception for furnishing of customary services for tenants 41:4
Welfare benefit funds 53:14

U.S. Virgin Islands
In general 70:5
Local taxation authority 70:6
"Mirror" tax system 70:1, 5
Possessions corporation tax credit 70:6
Residents 70:6
U.S. citizens or residents with Virgin Islands-source income 70:6

Utilities
Accounting method
—In general 24:1
—Contributions in aid of construction, inclusion in income 24:2
—Effective dates, transitional rules, TRA 1986 amendments 24:2, 3
—Real estate issues 76:9
ACRS ineligibility 4:10
Contributions in aid of construction, gross income treatment and exceptions 1:1, 2; 34:1
Nuclear power plants, qualified decommissioning fund contributions 24:4

V

Vacation pay
Fully vested vacation pay plans 53:15
Timing of employer deduction of accrued pay 51:4

Valuation
See also
—Special use real property valuation election
Accrued benefits 54:28, 30
Actuarial assumptions, valuation of contributions and benefits 54:4
Employer securities in ESOPs, valuation by independent appraiser when securities not readily tradable in securities markets 52:6
Imports 68:8
Incentive stock options 51:7
Statutory employee benefit plan coverage valuation 53:12
Stock for purposes of incentive stock option requirements 51:7

Vesting standards
Class year vesting repeal 54:8
Effective date, TRA 1986 amendments 54:9
Immediate vesting time of service requirements 54:8
Miniumum vesting standard regulations to be issued 54:36
Top-heavy plans 54:8
Vesting schedules 54:8
Years of service 54:8, 9

Veterans
Qualified veterans mortgage bonds 30:8, 10

Voluntary employees' beneficiary associations (VEBAs)
See also
—Nondiscrimination rules for certain statutory employee benefit plans
Prior law 53:2

Volunteer fire department bonds
See
—Tax-exempt bonds

W

Waivers
Death benefits by surviving spouses 57:11
Joint and survivor annuities 57:9
Qualified preretirement survivor annuities 57:9, 11

Welfare benefit funds
Account limit 53:14
Aggregation rules 53:14
Definition 53:14
Disqualified benefits 53:15
Effective dates 53:15
Excise tax on disqualified benefits 53:15
Nondiscrimination rules 53:13
Reserves for discriminatory post-retirement benefits 53:14
Study due date extension 51:4
Unrelated business taxable income 53:14

Windfall profits tax
Alternative minimum tax itemized deductions 32:22

Withdrawal restrictions of nonqualified plans
See
—Withdrawal restrictions of qualified plans

Withdrawal restrictions of qualified plans
In general 57:12
401(k) plans 54:27; 57:12, 13
Coordination with excise tax on excess distributions 57:18
Early retirement exception to premature withdrawal penalty tax 57:14
Effective dates 57:15
ESOP distribution exceptions to penalty tax 57:14
Five percent owners 57:15
Individual retirement arrangements 57:13, 15
Lump sum distributions pursuant to plan terminations exception to penalty tax 57:15
Medical expenses exceptions to penalty tax 57:14
Nonqualified annuities 57:15
Penalty tax 75:29
Periodic payments exception to penalty tax 57:13
Premature withdrawal penalty tax 57:13
Qualified domestic relations order requiring payment to alternate payee, exception to penalty tax 57:14
Tax-deferred annuities 57:12, 13

Withholding taxes
In general 58:1
Branch profits tax 62:4
Deferred payments outside U.S. 69:3
FIRPTA withholding
—Agent liability 72:7
—Distributions by partnerships, trusts, and estates 72:7, 8
—Exemptions 72:7
—Payment of tax 72:8
—USRPHC distributions 72:8
Foreign currency swap transactions 60:25
Partnership distributions to foreign partners 69:3, 4
Portfolio interest, repeal
—Direct ownership determination 72:5
—Excluded interest 72:5
—Pre-TRA 1984 law 72:4
—Refund claims by beneficial owners 72:5
—TRA 1984 amendments 72:4
Real estate transactions backup withholding 44:11
Royalties backup withholding where TIN not supplied 44:12

Worker-owned cooperatives
Estate tax liability assumption 52:7
Nonrecognition of gain or loss on sale of qualified securities to eligible worker-owned cooperatives under §1042 ... 52:7

Z

Zero-bracket amount
See
—Standard deduction

 © Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

TABLE OF PRINCIPAL INTERNAL REVENUE CODE SECTIONS ADDED, AMENDED, OR REPEALED BY THE TAX REFORM ACT OF 1986

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
1	101(a)	26, 29	345, 348	680, 681	76
1(a)	101(a)				10
1(b)	101(a)				10
1(c)	101(a)				10
1(d)	101(a)		596, 597		10
1(e)	101(a)		596, 597		47
1(f)	101(a)				10
	111(c)				14
1(g)	101(a)				10, 47
	1201	248			
1(h)	101(a)				10, 47
1(i)	402(a)		387		
	1411(a)			914	10
1(j)	302(a)	26		712	10, 76
	1601		595		
2(a)	1402(a)	266			
	1708(a)			934	
3(a)	102(b)			681, 682	
3(b)	141 (b)			683	
5(b)	141(b)			683	
11(b)	301(a)	72			
	601(a)			727	34
	611(a)		400, 401		
15(d)	101(b)			681	
23(b)	271(a)	67			
24	112(a)	31	362	691	15
25	1301(f)				15
	1311(b)				15
	1511		579, 589		
	1518(a)		579, 594		
	1562	312			
	1862		651		
25(b)	701(b)	167			
26(a)	701(c)			754	15
26(b)	261(c)				29
	701(c)				15
28(b)	1579(b)	320			
	1879(b)		658		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
28(d)	701(c)			754	15
28(e)	232			703, 704	14
	283	72			
29	273	69			
	1579(c)	320			
29(b)	701(c)			754	15
29(d)	1879(c)		659		
30	231				13, 15
30(a)	231(b)	56			
	231(c)			701, 702, 703	
30(b)	231(d)	56			
30(d)	231(b)			701, 702, 703	
	1301(b)		545		
30(e)	231(c)	58			
	1301(c)		547		
30(h)	231(a)	55, 56		701, 702, 703	
	1301(a)		544, 545		
32	672	150, 152			
32(a)	111(a)	30	350	683, 684	14
32(b)	111(b)		350	683, 684	
32(c)	972(c)		477		
32(f)	111(d)			683, 684	
32(i)	111(c)		350	683, 684	14
34(a)	1877(a)				73
38(b)	231(d)			701, 702, 703	
	252(a)				76
38(c)	221(a)			700	
	501(c)	54			
	631(a)		412, 413		
	701(c)			754	15
39(d)	231(d)				15
40	274(a)	70			
41	231				13
	231(d)				15
	1171(a)	246, 247		848, 849	15, 52
41(b)	231(e)			701, 702, 703	
42	252(a)			705, 706, 707, 708, 709, 710, 711	12, 15, 76
	1413(a)		563, 564, 565, 566		
46	211	43	362, 369, 416		11
	1802		605		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
46(b)	232(a)	59			
	251(a)			705	11, 76
	272	68			
	421				11
	711		362, 369, 416, 417		
	1412(a)		562, 563		
46(e)	1502(a)	272			
46(f)	211(b)			695	
47(a)	1502(a)	271			
	1802(a)		605		
48(a)	672(c)	150, 152			
	675(c)	150, 152			
	972(c)		477		
	975(c)		477		
	1502(a)	271			
	1802(a)		605		
48(b)	1509(d)	282			
48(g)	232(b)	59			
	251(b)			705	4, 11
	1412(b)		562, 563		
48(q)	232(c)	59			
	251(c)			705	
	1412(c)		562, 563		
	1809(c)		617		
48(r)	1879(i)		659		
49	211(a)	43	369	695	11, 76
	212				76
	213				76
51	282	71			
	1701			931	14
	1708		600		
53	701(b)			754, 758	14, 32, 33
	1101(b)		489		
55	701(a)			754, 758	15, 32, 33, 75
	1101(a)		489		
55(c)	252(c)				76
56	701(a)			754, 757, 758, 764	4, 8, 20, 32, 33, 75
	1101(a)		489		
56(a)	701				18
56(b)	701(f)				5

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1101(f)		496		
57	701(a)			754, 755, 756, 757, 758, 759, 760, 761, 762, 763	32, 33, 75
	1101(a)		489		
	1555	312			
	1855(a)		650		
57(a)	1509(a)	281			
	1809(a)		616		
58	502				17
	701(a)			754, 758	32, 33
	1101(a)		489		
58(b)	701				17
58(c)	1875(a)				47
59	701(a)			754, 758, 764	32, 33
	1101(a)		489		
62	131(b)			683	
	132(b)	34		690, 691	9
	133(b)		360		
	1575(c)	315			
	1875(c)		653, 654		
62(a)	132(c)			690	
63	102(a)	26	345, 349	681, 682	10
63(c)	972(c)		477		
67	132(a)	34		690, 691	8, 9, 32, 40, 47
71	1843			938	1
72	1222		518		
	1223		519		
	1552	305, 306			
	1852		642, 643		
72(b)	1122(c)	227		818, 819	57, 75
72(d)	1122(c)	228			57
72(e)	1122(b)			818, 819	
	1122(c)				57
	1826(b)				75
	1852(c)				57
72(m)	1123(d)				57
	1852(a)				57
	1898(c)				57
72(p)	1134	228		819	57
	1233		521		
72(q)	1123(b)			816	57, 75

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1526(c)	300			
	1826(c)		636		
	1852(c)				57
72(s)	1526	300			
	1826		636		1, 75
72(t)	1123(a)	226		799, 800, 815, 815, 816	52, 54, 55, 57
72(u)	1135	218, 219		799, 800	75
	1135(a)				57
	1234		505		
74	122(a)			351, 352, 685, 686	2
74(a)	123(b)			684, 685	
74(b)	123(b)	33, 34			
79(d)	1151(e)	237			
	1251(b)		530, 533		
	1527	300			
	1827		637		51, 75
81	805(c)				8
83(e)	1527(e)	300			
	1827(e)		637		51, 75
85	121		350	684	1
	122	31			
86(b)	131(b)			683	
89	1151(a)	237, 239		830, 831, 833, 836, 837, 839, 840, 841, 842	51, 53
	1251(a)		530		
101	1001				75
101(d)	1001	205	480	780	2
102(c)	122(b)			685, 686	2
	123(c)	33, 34			
103	701	153, 162			
	1301(a)			888, 889	30
	1513		579, 586, 591, 592		
	1514		579, 589		
	1515		579		
	1516		579		
	1518		579, 593		
	1566	312, 314			
	1567	312, 314			
	1568	312, 314			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1571	312, 314			
	1572	312			
	1573	312, 315			
	1574	312			
	1866		651, 652		
	1867		651, 652		
	1868		651		
	1872		651, 653		
	1873		651, 653		
103(b)	1501		579, 586		
	1570	312			
	1574	312			
	1870		651		
103(c)	1502		579, 585, 589		
103(d)	1503		579, 590		
103(e)	1504		579, 590		
103(f)	1505		579, 592		
103(g)	1506		579, 592		
103(h)	1565	312, 314			
	1865		651, 652		
103(l)	1507		579, 593		
103(m)	1509		579, 585		
	1871(a)		651, 653		
103(n)	1508		579, 590		
	1564	312, 313			
	1864		651, 652		
103(o)	1509		579, 585		
	1569	312, 314			
	1869		651, 652		
103(p)	1510		579, 586		
103A	701(b)	153, 162			
	1301(j)				30
	1511		579, 589		
	1512		579, 589, 593		
	1561	312			
	1563	312			
	1861		651		
105(h)	1151(c)			830, 832	
	1151(e)	237, 240			
	1251(b)		530, 532		
106	1151	237			
	1251		530		

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
108	405				76
	805(c)				8
	822				76
108(a)	323(a)		385		
	323(b)		385		
	822			776	
	822(a)				3
108(c)	323(b)		385		
108(g)	405(a)			715	3
	706(a)		419		
111	1512(a)	289			
	1812(a)		624		2
116	313	77			
	612				2
	612(a)		401	728	
117	123(a)	32		684, 685	2
117(d)	1251(c)		530, 532		
	1853(f)		646		51
118	824(a)				76
118(b)	824(a)			776	1, 24, 34, 76
	908(a)	201			
119(d)	1164(a)			844, 845	51
	1263(a)		538		
120	1151(e)	237			
	1251(c)		530		
	1262(c)		537		
120(e)	1161(b)	242			
	1162(b)			843, 844	51
125	1151(d)			841, 842, 844	
	1553(b)	307, 308, 309			
	1853(b)		645, 646		51
125(b)	1151(b)	237, 241			
	1151(d)				53
	1251(c)		530, 536		
125(c)	1151(d)				53
127(a)	1162(a)			843, 844	51
	1262(a)		537		
127(b)	1151(e)	237, 241			
	1251(c)		530, 532		
127(d)	1161(a)	242			
	1162(a)			843, 844	51
	1262(a)		537		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
129(a)	121(a)	31			
	1163(a)				51
129(d)	1151(e)	237, 241			
	1151(f)				53
	1163(a)				51
	1251(c)		530, 532		
129(e)	121(b)	31			
130	1002(c)		481		
130(c)	1002			780	2, 75
	1003(a)	205			
131	1707(a)			934	2
131(b)	1401(a)	266			
132	555		398		
	1251(a)		530, 532		
	1326	262			
	1553(a)	307, 308, 309			
	1567			927	
	1853(a)		645		51
	1853(e)		645		
133(a)	1173(b)				52
133(b)	1173(b)				52
133(d)	1172(a)	247, 248			
	1554(c)	311			
	1810(i)				72
	1854(c)		649		
134	1168(a)			846	51
135	1168			846	
141	701(b)	153, 162			
	1301(b)			889, 890	30
142	701(b)	153, 164, 176			
	1301(b)			892, 893, 894, 895, 896, 897	12, 30
143	701(b)	153, 167			
	1301(b)			897, 898	30
144	701(b)	153, 168, 169			
	1301(b)			897, 899, 900, 901	30
145	701(b)	153, 170			
	1301(b)			901, 902	30
146	701(b)	153, 175			
	1301(b)			905, 906	30
147	701(b)	153, 172			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1301(b)			902, 903, 904	30
148	1301(b)			907, 908, 909, 910	30
149	701(b)	153, 176			
	1301(b)			892, 912	30
150	701(b)	153, 174, 175			
	1301(b)			891, 904	30
151	103	26, 30	345, 349	682, 683	10
153	972		477		
162(a)	132(b)				9
162(k)	142(a)	36, 39, 41	355, 359		
	314	77			
	1895(d)				53
162(l)	142(a)		355		
	613(a)		401	730	34
162(m)	613(a)		401		
	1161			843	51
163(d)	402(a)	92, 93			
	511(a)				5, 32, 76
	1421(b)		577, 578		
163(e)	1503(a)	272			
	1510(e)	285			
	1803(a)		606		31
	1810(e)		620		72
163(h)	511(a)				57
	511(b)				5, 32, 76
	1421(a)		577, 578		
163(i)	984(a)		461		
164	132(a)				32
164(a)	134(a)			686	8, 9
	136(a)		354		
	1432(a)			915	
164(b)	134(b)			686	8, 9
	136(b)		354		
165	132(a)				9
165(h)	1002(a)	205			
	1004(a)			781	9
165(l)	803(a)		421		
	805(a)	186			
	905(a)			780	74
165(m)	803(a)		421		
166	303		382		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	805			773	
	906	199			
166(a)	303(b)		383		
	903(b)				74
	906(b)	200			
166(c)	303(a)		383		
	303(e)		384		
	805(a)				8
	906(a)	200			
166(f)	303(c)		384		
166(g)	303(c)		384		
167(c)	1509(c)	282			
	1809(c)		616, 617		
167(k)	223	55			
168	201(a)	43, 47	362, 366, 366	691, 692, 693, 694	4, 28, 32, 33, 76
	202	43			4
	203				4
168(b)	1509(a)	281			
	1809(a)		616		
168(f)	202(f)		369, 372		
	1509(a)	281			
	1509(b)	282			
	1809(a)		616		
	1809(b)		616		
168(h)	203(c)	43, 50			
168(j)	201(a)	48			
	1502(a)	271, 272			
	1802(a)		604, 605, 606		
169	222(a)	54			
170(e)	231(f)	58		703	9
	401(b)		387		
170(h)	1422				49
170(i)	133	35, 36			
170(k)	142(d)			689	6
	142(e)	36			
171	132(b)				9
171(b)	1503(a)	273			
	1803(a)		607		31
171(e)	643(a)			743	5, 31, 60
172(b)	702(b)	179			
	802		421		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	803(a)	185			
	903			779	74
	1517(b)		595		
	1807(a)				24
172(d)	401(b)		387		
175(c)	401				7
	701(a)		414		
	922(a)	202, 203			
177	221(a)	54			
	241(a)			704	8
	634(a)		412		
179(b)	201(b)	43, 50	362, 368		
	202(a)			695	4
179(d)	201(b)		362, 368		
	202(b)			695	4
	202(c)			695	4
180	921(a)	202, 203			
182	402(a)			713, 714	7
	702(a)		414		
	921(a)	202, 203			
183	132(b)				9
183(d)	143(a)	41	361	691	8
185	224(a)	55			
	242(a)			704	7
189	803(b)			772	76
190(d)	225	55			
	244			705	8
	1707		601		
194	911(a)	197, 202			
197	1002(a)		481		
212	132(b)				9
213	133				9, 32
	1261		536		
213(a)	133			686	
	134		354		
	1261		537		
216	132(b)				9
	644			743	39, 76
	1405	267			
	1703		603		
	1704		603		
219	1101	212		790	55

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1201		497		
	1575(c)	315			
	1875(c)		653, 654		
219(b)	1109(b)			802	
	1209(b)		507		
219(c)	1101(b)	213			
	1103(a)			791, 793	55
	1204(a)		497, 498		
219(d)	1101(a)	212			
219(e)	1101(b)			793	
219(g)	1101(a)			791	56
221	131(a)	26	345, 349	683	9
221(d)	1525(d)	299			
	1525(e)	299			
222	134(a)	36			
	135(a)			686	9
231	311(a)	73, 74			
232	311(a)	73, 74			
233	311(a)	73, 74			
234	311	73, 74			
243(a)	303(a)	75, 76			
	312(a)	75			
	611(a)		401	728	34, 67
244(a)	303(a)	75			
	611(a)		401	728	34
244(b)	611(a)	75	401	728	34
245(a)	987(a)		447		
	987(b)		447		
	1226(a)			871	
	1226(c)				67
	1576(d)	317			
245(b)	312(b)	75			
245(c)	1576(j)	317			
	1876(d)		655		72
	1876(j)		655		
245(e)	987(c)		447		
246(a)	1512(d)	290			
	1812(d)		625, 626		
246(b)	303(a)	75			
	611				34
	611(a)			728	
246(c)	1504(b)	274			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1804(b)				34
246(e)	675(b)	150			
	975(b)		477		
246A(a)	303(a)	75			
	611(a)		401	728	34
	1504(a)	274			
263(c)	251(b)	63			
	714(b)		419		
263(g)	1508(b)	281			
	1808(b)		615		
263(i)	251(a)	63			
	411(b)			716, 717	7
	714(a)		418		
263A	302(a)		376, 379, 380, 381		
	803(a)			770	5, 8, 19, 28, 76
	905(a)	192, 195, 196, 197			
264		205, 206			
264(a)	1003			781	5, 75
265(2)	802(b)	184			
	902(b)			778	74
265(6)	144	43	355	687	9
265(7)	1203(a)		497		
265(b)	802(a)	182			
	902(a)	184		778	74
267(a)	1512(c)	290			
	1812(c)		625		
269B	1810(j)				72
269B(b)	1510(j)	288			
	1810(j)		623		
274	555		398		
	1326	262			
	1567			927	
274(b)	122(c)		352	685, 686	
	123(b)	34			
	142(c)	39			
274(h)	142(c)		355, 359	689, 690	6
274(j)	122(d)		352	685, 686	2
	142(b)	36, 40			
274(k)	122(d)		352		
	142(a)			687, 688	6

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	142(b)	36, 41	355, 359		
274(l)	142(b)	36, 39	355, 359	688	6
274(m)	142(b)		355, 358	688, 689	6
274(n)	142(b)		355, 358	688	6
277(b)	1604(a)			931	8
278(c)	705(a)		415, 416		
280A(c)	143(b)				8
			361, 362		
	143(c)	42, 43	361, 362	691	8
280B	1578(g)	320			
	1878(g)		658		
280F	201(d)				8
280F(d)	1512(e)	291			
	1812(e)		626		8, 73
280G	1504(j)	277			
	1804(j)		611, 612		51
280H	132(a)		360		
280I	133(a)		360		
291(a)	412(b)			716, 717, 718	7
	643	133			
	643(a)	134			
	1504(k)	279			
	1576(b)	316			
	1804(k)		613		
	1876(b)		655		72
291(b)	411(a)			716, 717	7
291(e)	802(c)	182, 184			
	902(c)			778	
303(d)	1432(b)			915	48
304(a)	1575(b)	315			
	1875(b)		653		38
311	631				36
	631(c)			739, 740, 741, 742	37
312(b)	1504(f)	276			
	1804(f)		610		37
312(c)	1804(f)				37
312(k)	201(b)				4
	1509(a)	281			
	1809(a)		616		
312(n)	1804(f)		610		37
332(b)	1504(e)	275			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
333	631(e)				36
336	331(a)	85, 89, 90			
	631(a)			739, 740, 741, 742	36
337	332	85, 89, 90			
	631(a)			739, 740, 741, 742	36
	1504(e)	275			
338	333	85, 89, 90			
338(a)	631(b)			739, 740, 741, 742	36
338(c)	631(b)			739, 740, 741, 742	36
338(d)	1504(e)	275			
338(h)	631(b)			739, 740, 741, 742	36
	675(c)	150, 152			
	975(c)		477		
341(a)	1504(i)	277			
	1804(i)		611		
361	1504(g)	277			
	1804(g)		610, 611		38
362(c)	824(b)			776	24, 76
	908(b)	201			
367(d)	641(e)	131, 132			
	1231(e)				66, 68
367(e)	631(d)				36
	1510(g)	287			
	1810(g)		622		72
368(a)	804(a)	185, 186			
	904(a)			779	74
	1804(g)		610, 611		
	1804(h)		610, 611		
	1879(k)		660		
368(c)	1804(h)				38
382	321(a)	77, 83			
	621(a)		402, 406, 407	730, 731, 732, 733, 734, 735, 736, 737, 738, 739	35
	804	185, 186			
383	321(a)	77			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	621(b)		404, 409	730, 731, 732, 733, 734, 735, 736, 737, 738, 739	35
386	1805		613		
	1881				37
386(d)	1505(c)	279			
	1805(c)		613		37, 37
401	1137	235			
401(a)	1106(d)			822, 824	54
	1111(b)				54
	1112(b)			806	54
	1114(a)	223			
	1116(a)	220, 224			
	1119(a)			812	54
	1121(b)	224, 225		815	57
	1136(a)			826	54
	1145(a)			828	54
	1171(b)	246, 247			
	1173(a)	243, 244, 245			
	1174(c)			848, 849	52
	1175(a)			847, 849	52
	1176(a)			849	52
	1212(b)		508, 511		
	1214(b)		508		
	1217(b)		503		
	1219(a)		516		
	1221(b)		516		
	1235(a)		528		
	1552(a)	305			
	1852(a)		642, 643		57
	1852(b)		642, 643		
	1897(b)		666, 667		
	1898(b)				57
401(c)	1143(a)			826	54
	1237(a)		528		
401(h)	1852(h)		645		
401(k)	1111	214, 215, 226			
	1116(a)			793, 795	54
	1116(b)			793, 795	57
	1216		499, 500		
	1552(g)	307			
	1579(g)	320			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1852(g)		644		
	1879(g)		659		
401(l)	1111(a)			807, 810	54
	1115(a)				54
	1211(a)		513		
401(m)	1112(a)	216			
	1117(a)			796, 797	54
	1217(m)		503		
402	1122			817	
	1601(d)	329			
402(a)	1122(b)	227		818	57
	1122(e)			819	57
	1221(c)		517		
	1552(a)	305			
	1575(c)	315			
	1852(b)		642, 643		55, 57
	1852(c)		642, 643		
	1875(c)		653, 654		
	1898(a)				57
	1898(c)				57
402(b)	1112(c)				54
402(e)	1106(c)				54
	1122(a)	227		818	57
	1122(b)	227		818	
	1222(a)		518		
	1897(a)		665, 666		
	1898(a)				57
402(f)	1223(c)		521		
	1897(e)		672		
	1898(e)				57
402(g)	1102(a)	213, 214, 219, 220			
	1105(a)			793, 800, 801	54, 56
	1205(a)		499		
	1223(c)		521		
	1854(g)		650, 651		
402(h)	1108(b)				55
403(a)	1122(b)	227	518	818	57
	1122(d)	227		818	57
	1221		518		
403(b)	1113(a)	220			
	1120(a)			804, 805	56

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1121(d)	224			
	1122(d)	227			56, 57
	1123(c)	226			57
	1552(b)	305			
	1852(a)			938	
	1852(b)		642, 643		
403(c)	1122(d)	227			57
404(a)	1131(a)	232		824, 825	54
	1131(b)				54
	1231(a)		525, 526, 527		
	1575(c)	315			
	1875(c)		653, 654		
404(b)	1851(b)			938	
404(h)	1108(c)				55
404(i)	1171(a)	246, 247			
404(k)	1172(b)	247, 248			
	1173(a)			848, 849	52
	1554(b)	311			
	1854(b)		649		52
404(l)	1106(d)				54
	1131(a)	233			
	1131(b)	234			
	1131(c)	234			
408(a)	1852(a)		642, 643		55, 57
408(b)	1852(a)	305			55, 57
408(d)	1102(c)				55, 57
	1121(c)	224			
	1202(b)		498		
	1202(c)		498		
	1221(c)		516		
	1552(a)	306			
	1575(c)	315			
	1852(a)				55
	1875(c)		653, 654		
408(f)	1123(d)				57
408(i)	1102(e)			793	
408(k)	1108(a)			801	54, 55
	1108(d)				55
	1202		497		
	1208(a)		506		
	1898(a)				55
408(m)	1144(a)				55

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
408(o)	1102(a)			792	55
	1202(a)		497, 498		
409(d)	1174(a)	246, 247		848, 849	
	1275(a)		543		
409(e)	1173(b)	243, 245			
	1176(b)				52
	1854(f)		650		
409(h)	1173(c)	246			
	1174(c)			848, 849	52
	1275(c)		544		
409(l)	1176(b)			848, 849	
409(o)	1174(b)			848, 849	52
	1275(b)		543		
410(a)	1113(c)			807	54
	1113(d)				54
410(b)	1112(a)			802, 803	52, 54
	1112(b)				56
	1113	220			
	1212(a)		508, 509, 510		
411(a)	1113(a)			806, 807	54
	1113(d)				54
	1139(a)			826, 827	54
	1213(a)		512, 513		
	1238(a)		529		
	1897(d)		672		
	1898(d)				57
411(d)	1113(b)			807	54
	1897(a)		665, 666		
	1897(f)		672		
412(i)	1131(b)			825	
414	1552(f)	307			
	1852(f)		644		
414(n)	1146(a)			829	54
414(o)	1146(b)			829	
414(p)	1601(c)	328			
	1897(c)		670, 671		
	1898(c)				57
414(q)	1114(a)			812, 814	53, 54
414(r)	1115(a)			838	53, 54
	1215(a)		510		
414(s)	1115(a)				54
415(b)	1103(a)	230			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1103(b)	230			
	1103(f)	230			
	1106(b)			822, 823	54
	1106(f)			821, 823	54
	1206(b)		522, 524, 525		
415(c)	1103(a)	230			
	1106(a)			820, 823	54
	1106(b)			823	54
	1106(e)				54, 56
	1174(d)			848, 849	
	1206(a)		522, 524		
	1275(d)		542, 544		
415(d)	1206(g)		524, 525		
415(k)	1103(c)	231			
	1106(c)			821, 823	54
	1206(c)		524		
415(l)	1552(h)	307			
	1852(h)		644, 645		54
416(g)	1115(a)	223, 224			
	1118			812	
	1118(a)				54
	1218		516		
	1218(a)		515		
	1852(d)		643, 644		
416(i)	1852(d)		643, 644		
417	1238		529		
	1601(b)	326			
	1897(b)		666, 667, 668, 669, 670		
	1897(d)		672		
417(a)	1897(b)		668, 669		
	1898(b)				57
417(c)	1897(b)		668		
	1898(b)				57
417(c)	1139(b)				54
417(f)	1897(b)		668, 670		
	1898(b)				57
419(e)	1851(a)			938	53
419(g)	1551(a)	302			
	1851(a)		638		
419A	1551	302, 303			
419A(c)	1851(a)		638, 640		53

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
419A(d)	1851(a)		638, 639		
419A(e)	1851(a)		638, 639, 640		53
419A(f)	1851(a)		638, 640, 641		
419A(g)	1851(a)		638		53
419A(h)	1851(a)		638, 640		53
422A	1555(a)	312			
	1855(a)		650		
422A(b)	321(a)			712	51
	411(a)		387		
422A(c)	321(b)				51
	411(b)		387		
441(f)	806(d)			774	23
441(i)	304(c)		385, 386		
	806(c)			774	23
448	321(a)		372		
	801(a)			765, 766	8, 22
	902(a)	189			
451	904	192, 197			
451(f)	322(a)		373		
	821(a)			775	24
	905(b)			780	74
453	642				25
453(f)	642(b)			742, 743	
453(i)	313(a)		384		
	1809(c)				18
453(j)	312(a)		373, 376		
	812(a)			767, 768, 769, 770	18
453A(Q)	312(b)		376		
453B(d)	631(e)				18
453C	311(a)		373, 374, 375		
	811(a)			767, 768, 769, 770	18, 76
	903(a)	190, 191			
457	1104(a)	217, 218			
	1107(a)			798, 799	51
	1207		504		
457(c)	1107(a)				56
459	904	197			
460	301(a)		376, 380		
	804(a)			772	20, 76
461(h)	805(c)				8

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1507(a)	280			
	1807(a)				24
461(i)	801(b)			765, 766	22
	1507(a)	280			
	1807(a)		614, 615		24
463(a)	325(a)		539		
	907(a)	200, 201			
	1165(a)			845, 846	51
464	404(b)			714	
	704(b)		415		
464(a)	704(a)		415		
464(b)	704(a)		415		
464(f)	404(a)			714	7
	704(a)		415		
465(b)	401(b)	91			
	503(b)			720	16, 76
465(c)	401(a)	92			
	503(a)			720	15, 16
	1411(a)		561		
466	324(a)		384		
	823(a)			775	8
467	1807(a)		615		
467(g)	1507(b)	280			
	1807(b)				24
468(a)	1507(a)	280			
	1807(a)		615		24
468(g)	1807(a)				24
468A(g)	1507(a)	280			
	1807(a)		615		
468B	1807(a)		614		24
469	501(a)			721, 722, 723, 724, 725, 726	15, 17, 32, 76
	1401(a)		550		
474	802(a)			766, 767	21
	901(a)	186, 187			
481	803			771	
482	641	131			
	1231(e)				66, 68
483(d)	1803(a)				31
501(c)	1024(a)		488		
	1024(b)			790	
	1025(a)	211			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1109(a)			802	55
	1162				51
	1209(a)		507		
	1603(a)			930	50
	1879(j)		660		
501(m)	1012(a)	206, 207		782	75
502	1601(c)	328			
	1897(c)		670, 671		
505(b)	1151(c)	237, 241			
	1251(c)		530		
	1551(c)	302			
	1851(c)		638		
512(a)	1551	302, 304			
	1851(a)		638, 640		53
513	1533	301			
	1833		638		
513(d)	1602			930	50
513(h)	1404(a)	267			
	1601(a)			929, 930	50
	1702(a)		601, 602		
514(c)	1578(d)	319			
	1603(b)			930	50
	1878(d)		658		
521(b)	924(b)	203, 204			
532(b)	1235(f)				64
535(b)	626(a)	136			
	926(a)		464		
	1225(a)			871	71
541	104(b)				38
542(c)	1235(f)				64
543(a)	645			753, 754	
	1302(a)		549		
	1406(a)	268			
543(d)	645(a)				38
	1302(b)		549		
	1406(b)	268			
545(b)	626(b)	136			
	926(b)		464		
	1225(b)			871	71
551(f)	1510(h)	288			
	1810(h)		622		
551(g)	1235(e)				59, 64

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
552(a)	622(b)	125			
	922(b)		446		
	1222(b)			865, 871	63, 71
552(c)	1510(h)	287			
	1810(h)		622		72
553(a)	1302(c)		549		
562(b)	1504(d)	275			
562(c)	657(a)			753	40
582(c)	671(b)				42
585	801	179, 180			
	901(a)			776, 777	74
593	801		420		
	801(b)	181, 182			
	901(b)			777, 778	74
593(d)	671(b)				42
597	804(b)	185, 186			
	904(b)			779	74
613	261	66			
613(e)	254	64			
	412(a)				7
613A(c)	252(a)	64			
613A(d)	253(a)	64, 65			
	412(a)			716, 717, 718	7
616	262(a)	67			
616(a)	715(c)		419		
616(c)	262(a)	62			
616(d)	411(b)				7
	715(a)		419		
617	262(c)	67			
617(d)	413(b)			717, 718	
617(h)	716(b)		419		
631(a)	912(b)	202			
631(c)	242(a)	62			
631(d)	912(a)	202			
641	1211	249, 252			
642	1211	249, 252, 253			
642(c)	401(b)		387		
643	1211	249, 252			
643(a)	401(b)		387		
643(d)	1806(a)				47
643(e)	1506(a)	279			
	1806(a)		614		47

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1806(b)				47
643(f)	1806(b)				47
643(g)	1404(b)			912, 913	47
644	1211	249, 252			
645	1211	249, 253			
	1403(a)			912, 914	47
	1613(a)		598		
646	1211	249, 252			
651	1211	249, 252			
652	1211	249, 252			
653	1211	249, 253			
661	1211	249, 254			
662	1211	249, 252			
663	1211	249, 253			
664	1211	249, 252			
665	1211	249, 253			
666	1211	249, 253			
672(e)	1401(a)			912, 913	47
	1611(a)		597, 598		
673	1402(a)				47
	1612(a)		597, 598		
674(b)	1612(a)		597, 598		
676(b)	1612(b)		597, 598		
677(a)	1612(b)		597, 598		
691(c)	401(b)		387		
692(b)	1402(a)	266			
	1708(a)			934	
706(b)	304(a)		385, 386		
	806(a)			774	23
706(d)	1505(a)	279			
	1805(a)		613		43
707(a)	1505(b)	279			
	1805(b)		613		43
707(b)	642(a)				25
761(e)	1505(c)	279			
	1805(c)		614		
804	1011(b)				75
805(a)	611(a)		401	728	34
	1521(p)	296			
	1821(p)		631		75
805(b)	805(c)				8
806	1011		482		75

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
806(a)	1011(a)	206	482	781, 782	
807	1821				75
	1823				75
807(c)	1022(b)		483		
	1023(b)			786	75
	1521(a)	291			
	1821(a)		626, 627		
807(d)	1022		483, 487		
808	1521(c)	292			
	1821				75
	1822				75
808(d)	1521(b)	292			
	1821(b)		627		
808(f)	1821(c)		627		
809	1821				75
	1823(b)		633		
809(b)	1521(d)	292			
	1821(d)		628		
809(c)	1521(g)	293			
	1821(g)		628, 629		
809(d)	1521(e)	293			
	1821(e)		628		
809(f)	1521(h)	293			
	1821(h)		628, 629		
809(g)	1521(f)	293			
	1821(f)		628		
809(i)	1521(q)	296			
	1821(q)		631		
810	1013			784	
812	1521(i)	294			
	1821(i)		629		75
813(a)	1521(j)	294			
	1821(j)		629, 630		
815	1013			784	75
	1521(k)	294			
	1821(k)		630		75
816(h)	1521(l)	295			
	1821(l)		630		75
817	1821				75
817(h)	1521(m)	295			
	1821(m)		630		
818	1821				75

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
818(a)	1521(n)	295			
	1821(n)		631		
818(e)	1521(o)	296			
	1821(o)		631		
821	1024		488		
821(a)	1025(b)	211			
822	1024(a)			790	75
823(c)	1024(d)		488		
824	1023(a)		487, 488		
	1024(a)	210		789	75
825	1024(a)	210		789	
826	1024(a)	210		790	75
831	1024(a)			790	
832(b)	1021(a)	208	482, 483	784, 785	75
	1022(a)	208, 209	483, 484, 487	785	75
	1023(c)			785, 786	75
833	1012(b)			782	75
834	1024(c)			790	75
835	1024(c)			790	75
846	1021(c)		483, 484		
	1022				75
	1023(a)	209, 210			
	1023(c)			786	75
847	1024(c)		488		
	1025(c)	211			
851(a)	652(a)			753	40
851(b)	653(b)			753	40
	1235(f)				64
851(e)	652(b)			753	40
851(g)	653(a)			753	40
852	651(b)				40
	1578(i)	320			
	1878(i)		658		
	1878(j)				40
852(b)	651(b)			752	40
	1173(b)				52
	1504(c)	274			
	1804(c)				40
852(c)	651(b)			752	40
854(b)	655(a)				40
855(b)	651(b)				40
855A	633(a)		413		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
856(a)	661(a)			743, 744, 745, 746	
	1431(a)		567, 570		
856(c)	662(b)			743	41
	671(b)				42
	1441(b)		576		
856(d)	663(a)			743	41
	663(b)			743	41
	1433		567, 570		
856(h)	661(a)				41
856(i)	662(a)			743	41
	1432(a)		567, 570		
856(j)	662(c)			743	41
857	1434		567, 570		
857(a)	661(b)			743, 744, 745, 746	
	664(a)			743	41
	668(b)			744, 745	
	1431(a)		567, 570		
857(b)	665(a)			744	41
	666(a)			744	41
	668(b)			744	41
	1435		567, 571		
	1436		567, 571		
857(d)	668(b)				41
857(e)	664(b)			743	41
859(b)	661(c)			743, 744, 745, 746	41
860A	671(a)			746, 747, 748	42
	1441		571, 575		
860B	671(a)			746, 749	42
	1441		571, 575		
860C	671(a)			746, 749	42
	1441		571, 575		
860D	671(a)			746, 747	42
	1441		571, 574		
860E	671(a)			746	42
	1441		571, 575		
860F	671(a)			746, 748	42
860G	671(a)			746	42
861(a)	611(b)	112			
	612(b)	114			
	651(b)	135			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	911(b)		435		
	912(a)		435		
	912(b)		435		
	951(b)		454, 455		
	1214			862, 863	61
861(b)	616(a)	119, 120			
	1303(a)		547, 549		
	1516			865	
861(c)	612(b)	114			
	912(b)		435		
	1214(a)				61
861(d)	612(b)	114			
	912(b)		435		
861(e)	613(d)	115			
	615	118, 119			
	913(d)		437		
	1212(d)			861, 862	
861(f)	913(d)		437		
862(a)	911(b)		433		
862(b)	611(b)	112			
	616(a)	119, 120			
	1303(a)		547, 549		
	1516			865	
863(b)	616(a)	119, 120			
	911(b)		433		
	1303(a)		547, 549		
	1516			865	
863(c)	613(a)	115			
	615	119			
	913(a)		436		
	1212(a)			861, 862	61
863(d)	615(a)	128			
	915(a)		442		
	1213(a)			862, 863	
863(e)	915(a)		442		
	1213(a)			862	61
864	614(b)	115, 117			
	675	150			
	914(b)		437, 439		
	975		477		
	985		458		
864(c)	652	136			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	952		457		
	1242			878	71
864(d)	675(c)	152			
	1510(c)	284			
	1810(c)		618, 619		72
864(e)	614(a)	115, 117			
	914(a)		439, 440		
	1215(a)			863, 864	61
865	611(a)	111, 112			
	911(a)		433		
	1211(a)			861	61
871(a)	401(b)		387		
	911(b)		434		
	1510(e)	285			
	1810(e)		620		72
871(e)	911(b)		434		
	1211(b)			861	
871(h)	1510(d)	284			
	1810(d)		619		72
871(i)	612(b)	114			
	912(b)		435		
	1214(c)			862, 863	61
871(j)	912(b)		435		
872(b)	613(c)	139			
	913(c)		435, 436, 437		
	1212(c)			861, 862	61
875	985		458		
876	672(b)	152			
	972(b)		477		
	1272(b)			887	70
877(c)	653(a)	136			
	953(a)		457		
	1243(a)			878	71
	1277(e)				70
881	951		454, 456		
881(a)	611(b)	112			
	911(b)		434		
	1510(e)	285			
	1810(e)		620		72
881(b)	673(b)	150, 152			
	973(b)		477, 479, 480		
	1273(b)			887	70

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
881(c)	1510(d)	284			
	1810(d)		619		72
881(d)	612(b)	113, 114			
	912(b)		434, 435		
	1214(c)			862, 863	61
881(e)	912(b)		435		
882(e)	645(a)	150, 152			
	944(a)		477		
	1236(a)				70
883	651(a)	134, 135			
883(a)	613(c)	139			
	913(c)		436, 437		
	1212(c)				61
883(c)	613(c)	139			
	913(c)		437		
	1212(c)				61
884	651(a)	134			
	951(a)		454		
	1241(a)			876, 877	62, 76
885	651(c)	134			
886	613(b)	139			
	913(b)		437		
887	613(b)	139			
	1212(b)			861, 862	61
892	982		459		
	1247(a)			879	
	1247(b)				71
897(i)	1510(f)	285			
	1810(f)		620, 621		72
901(i)	602(a)	108			
	902(a)		432		
	1204(a)			860	59
902	904(a)		422, 426, 430		
	1202(a)			859	59
	1576(d)	317			
	1876(d)		656		
904(c)	1205				59
904(d)	601	102, 106, 107			
	661(b)	140			
	901		422, 426, 427, 428, 447		
	1201			850, 851, 853	59, 72

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1510(b)	283			
	1576(d)	317			
	1810(b)		617, 618		
	1876(d)		656		72
904(f)	603(a)	102, 104			
	903(a)		431		
	1203(a)			859	59
904(g)	987(d)		422, 426, 447, 448		
	1235(f)				64
	1510(a)	282			
905(c)	961		464, 475, 476		
906(b)	1576(d)	317			
	1876(d)		656		
911	1233				71
911(b)	644(a)	134			
	943(a)		450		
	1233(a)			873	71
911(d)	988(a)		450		
912	642(b)	133			
	942		450		
	1232(b)			873	
912(l)	942(b)		450		
923(a)	643(a)	133, 134			
	1576(b)	316			
	1876(b)		655		
924(c)	1876(e)				72
924(f)	1576(l)	318			
	1876(l)		657		
927(d)	1576(a)	316			
	1876(a)		654, 655		
927(e)	1576(e)	317			
	1576(f)	318			
	1876(e)		656		72
	1876(f)		656		72
931	672(a)	150, 152			
	972 (a)		477		
	1272(a)			887	70
932	672(c)	151, 152			
	674(a)	150, 153			
	972(c)		477		
	974(a)		477		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1272(d)				70
	1274 (a)			887	70
933	972(c)		477		
934	641	128			
	675	150, 152			
	941		448		
	975		477		
934A	675	150, 152			
	975		477		
935	972(c)		477		
936	641	128, 131			
	675	150			
	941		448		
	975		477		
	1231			872, 873, 874	66, 68
936(a)	941(d)		449		
936(b)	641(b)	130			
	941(b)		449		
936(d)	641(c)	130			
	675(a)	153			
	941(c)		449		
	975(a)		450		
	1275(a)			887	
936(h)	641(a)	130			
	941(a)		449		
951	1235(c)				64
	1576(c)	317			
	1876(c)		655		
952	1221(f)			865, 869	
	1576(c)	317			
	1876(c)		655		
952(c)	1221				63
952(d)	1221(f)				59
953	621(b)	121			
	1221(b)				63
953(a)	621(b)	124			
	1221				63
	1221(b)			865, 867	
	1223				63
953(c)	1221(b)			865	
954(b)	621(c)	124			
	621(d)	125			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	623(b)	126			
	923(a)		446		
	1221(c)			865, 867	63
	1221(d)			865, 869	59
	1223(a)			865, 871	59, 63
954(c)	621(a)	123			
	921(a)		444, 445		
	989		442		
	1221(a)			865, 867	63, 64
954(d)	621(e)	125			
	921(b)		446		
	1221(e)			865	63, 72
954(e)	1510(k)	288			
	1810(k)		623		72
954(f)	1221(c)				63
956(b)	1510(c)	284			
	1810(c)		618, 619		
957	673	150			
	924		447		
	973		477		
	1222			865	59
	1222(a)				71
	1224			865, 871	70
	1273(a)				70
957(a)	622(a)	125			
	922(a)		446		
	1222(a)			865, 871	63
957(c)	624(a)	126			
	924(a)		446, 447		
	1224(a)				63
	1273(a)			887	
957(d)	624(b)	126			
	673(a)	152			
	924(a)		447		
959(d)	1226(b)				67
960(a)	904(b)		422, 426, 430		
	1202(b)			859	59
985	661(a)	140, 147, 148			
	961(a)		464, 471		
	1261(a)			880	60
986	661(a)	140, 149			
	961(a)		464		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1261(a)			884	60
987	661(a)	140, 149			
	961(a)		464		
	1261(a)			885	60
988	661(a)	140, 148			
	961(a)		464, 471, 473, 474, 475		
	1261(a)			881, 882, 883	26, 60
989	661(a)	140, 147			
	961(a)		464, 472		
	1261(a)			881, 884, 886	60
995(b)	643(b)	133, 134			
	1576(b)	316			
	1876(b)		655		72
995(f)	1576(g)	318			
	1876(g)		656		72
996(a)	1576(k)	318			
	1876(k)		657		
1016(a)	702(b)	179			
	1517(b)		595		
1017	405				76
	822				76
1017(b)	405(b)			715	3, 76
1031(a)	1505(d)	279			
	1805(d)				43
1031(d)	1805(d)		614		
1034(h)	1578(f)	319			
	1878(f)		658		
1035(b)	1528	301			
	1828		637		75
1042	1172	247			
	1175	247			
	1554(a)	310			
	1854(a)		647, 648		
1042(b)	1854(a)				52
1042(c)	1175(a)	247, 248			
	1854(a)				52
1042(e)	1854(a)				52
1042(g)	1172(c)	247, 248			
1059	614(a)		409, 410		
1059(a)	614(a)		410	728, 729	37
1059(c)	614(b)		410	728, 729	37

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	614(c)		410		
1059(d)	614(a)				37
	614(c)		410	728, 729	
	1014(d)				37
1059(e)	614(e)			728, 729	37
1059A	981		460		
	1248			880	71
1060	632(a)		410, 411		
	641(a)			742	27
1061	632(a)		410, 411		
1092	331				26
	422		387		
	961		464, 475		
	1261				26
	1808		616		
1092(c)	331			712, 713	
	331(a)			712, 713	26
	422(a)		387, 388		
1092(d)	961(c)		464, 475		
	1261(b)				26
	1508(c)	281			
	1808(c)		616		
1201	302	72			
	302(a)	72			
	311(a)			712	34, 72
1202	241(a)	62			
	301(a)			712	2, 76
	302(c)				76
	401(a)		387		
1202(a)	241(a)	62			
1211(b)	401(b)		387		
1212(b)	401(b)		387		
1212(c)	421(b)		388		
1235(e)	925(a)	204			
1239(b)	642(a)			742, 743	25
1239(c)	642				25
1245(a)	201(d)				28
	201(e)		368, 369		
1246(b)	625(a)	127			
1246A	625(b)	127			
	925		452		
1246(f)	625(c)	127			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	925(b)		452, 454		
1248	1576(a)	316			
1248(d)	1576(a)	316			
	1876(a)		654, 655		
1248(i)	1510(i)	288			
	1810(i)		622, 623		
1250	202	43			
1254	243	62			
	413(a)			717, 718	28
1254(a)	243	62			
1256	421		387		
	961		464, 473, 474, 475		
	1808		615		
1256(d)	961		474		
1256(e)	961(d)		464, 473, 474, 475		
	1261(c)				26, 60
1257	403(a)			714	28
	703(a)		414		
	923(a)	203			
1271	1503(a)	272			
1271(a)	1803(a)		606		31
1272(a)	672			751	31, 42
	1442(a)		571, 576		
1273(b)	1503(a)	273			
	1803(a)		607		
1274(c)	1803(a)				31
1276(a)	1803(a)				31
1276(d)	1503(a)	272			
	1803(a)		606		31
1278(a)	1503(a)	273			
	1803(a)		606, 607		31
1281(a)	1503(a)	273			
	1803(a)		607		31
1281(b)	1503(a)	273			
	1803(a)		607		
1282(a)	1803(a)				31
1286(b)	1803(a)				31
1291	1235(a)			875	64
1292	1235(a)				64
1293	1235(a)			876	59, 64

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
1294	1235(a)			876	64
1295	1235(a)			876	64
1296	1235(a)			876	64, 67
1297	1235(a)			876	64
1301	141(a)	36	350	683	10
1302	141(a)	36	350	683	10
1303	141(a)	36	350	683	10
1304	141(a)	36	350	683	10
1305	141(a)	36	350	683	10
1332	1173(b)			848, 849	
1341	132				9
1361(d)	1879(l)		660		
	1879(m)				43
1362	331	85			
1368(e)	1879(m)				43
1374	631				36
	632(a)				38
	633(d)				38
1378(a)	304(b)		385, 386		
	806(b)			774	23
1378(b)	304(b)		385, 386		
	806(b)				23
1378(c)	304(b)		385, 386		
1388(j)	924(a)	203, 204			
1391	702(a)	179			
	1303(a)			912	
	1517(a)		595		
	1518		595		
1392	702(a)	179			
	1303(a)			912	
	1517(a)		595		
	1518		595		
1393	702(a)	179			
	1303(a)			912	
	1517(a)		595		
	1518		595		
1394	702(a)	179			
	1303(a)			912	
	1517(a)		595		
	1518		595		
1395	702(a)	179			
	1303(a)			912	

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1517(a)		595		
	1518		595		
1396	702(a)	179			
	1303(a)			912	
	1517(a)		595		
	1518		595		
1397	702(a)	179			
	1303(a)			912	
	1517(a)		595		
	1518		595		
1402	972		477		
	1585	321			
	1882		660, 661		
1402(e)	1704			932	
	1704(a)				58
	1704(b)				58
1402(g)	1882(a)				58
1402(i)	401(b)		387		
1402(j)	1882(b)				58
1441	985		458		
1441(c)	612(b)	113			
	912(b)		434		
	1510(d)	284			
	1810(d)		619		
1442	612	113			
	912		434		
	985		458		
1442(a)	1510(d)	284			
	1810(d)		619		
1442(c)	973(b)		477		
1445	952		463, 464		
1445(b)	1510(f)	287			
	1810(f)		620, 621		72
1445(d)	1510(f)	285, 287			
	1810(f)		620, 621		72
1445(e)	1510(f)	285, 287			
	1810(f)		620, 621, 622		72
1446	985(a)		458		
	1246(a)			879	69
1503(d)	1249(a)			880	65
1504	983		460		
	1504(a)	275			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
1511	1512(a)	289			
	1812(a)		624		
2032(c)	1432(c)			915	
2032A	1421				49
	1615		599		
	1616		599		
2039	1552(e)	307			
	1852(e)		644		
2039(c)	1852(e)				57
2055	1422(a)			915	
2055(e)	717(a)		419		
2055(f)	717(a)		419		
	1422(a)				49
2055(g)	717(a)		419		
2057	1172			849, 850	
	1172(a)				52
	1273		541		
2210	1172	247			
	1554(d)	311			
	1854(d)		649, 650		
2210(c)	1854(d)				52
2210(h)	1172(d)	248			
2515	1432(d)			915	
2517	1552(e)	306, 307			
	1852(e)		644		
2518	1617		599, 600		
2522	1422				49
	1422(b)			915	
2522(d)	717(b)		419		
2522(e)	717(b)		419		
2523	1879(m)		660		
2601	1221	254, 255, 256			
	1431			915	48
2602	1221	254, 256			
	1431			915	48
2603	1221	254, 255			
	1431			915	48
2604	1221	254, 256			
	1431			915	48
2611	1221	254, 256			
	1431			915	48
2612	1221	254, 256			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1431			915	48
2613	1221	254, 255			
	1431			915	48
2621	1221	254, 256			
	1431			915	48
2622	1221	254, 256			
	1431			915	48
2623	1221	254, 255			
	1431			915	48
2624	1221	254, 257			
	1431			915	48
2631	1221	254, 256			
	1431			915	48
2632	1221	254, 256			
	1431			915	48
2641	1221	254, 256			
	1431			915	48
2642	1221	254, 255			
	1431			915	48
2651	1221	254, 256			
	1431			915	48
2652	1221	254, 255			
	1431			915	48
2653	1221	254, 256			
	1431			915	48
2654	1221	254, 257			
	1431			915	48
2661	1221	254, 255			
	1431			915	48
2662	1221	254, 255			
	1431			915	48
2663	1221	254, 255			
	1431			915	48
3121	1585	321			
	1882		660, 661		
3121(a)	1151(d)			844	
3121(w)	1882(c)				58
3302(f)	1590(2)	322			
	1884		662		
3306	1590(3)	322			
	1705			933	58
	1884		662		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
3306(a)	707(a)		416		
3306(b)	1151(d)			844	
3401(a)	1272(c)			887	70
3402	562(a)		399		
	562(c)		399		
	1335	263			
	1572			928	
3402(i)	562(b)		400		
3402(r)	702(b)	179			
	1517		595		
3405	986(a)		451, 452		
	986(b)		451, 452		
3405(d)	1102(e)			792	
	1234(b)				69
3406(b)	1523(b)				44
3406(h)	1521(b)			919	44
3507	111	30			
4041	275	70			
	1351	265			
	1578(c)	319			
	1702				73
	1702(a)			932	
	1703				73
	1878(c)		657		
4041(b)	422(a)			719	
	713(a)		417, 418		
4041(l)	1878(c)				73
4051(d)	921				73
	1577(c)	319			
	1877(c)				73
4064	1512(e)	291			
	1812				8
	1812(e)		626		
4064(b)	1812(e)				73
4081	712		417, 418		
	1703			932	73
4082	1703			932	73
4083	1703			932	
4101	1703(b)			932	
4162(a)	1878(b)				73
4251	1501(b)	270			
4261	1578(c)	319			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1878(c)		657		
4261(e)	1878(c)				73
4371	654(a)	137, 138			
4374	654(b)	138			
4375	654(c)	138			
4471	1403	266			
4472	1403	266			
4940	1532	301			
	1832		637		
4941(b)	1812(b)				31
4943	1705		602, 603		
4946(c)	1606				50
4972	1131(c)			825	54
	1131(d)	232, 234			
	1231		525		
4973(b)	1102(b)			792	
4974	1121	224			
	1121(a)	225		815	57
	1221		516		
4976	1551	302, 304			
	1851(a)		638, 641		
4976(b)	1851(a)				53
4977	1553	307, 308			
	1853(c)		645, 646		51
4978	1554(a)	310			
	1854(a)		647		
4979	499		499		
	1112(b)	215, 216, 217			
	1117(b)				54, 55
	1216		499, 502		
	1217		503		
	1854(a)				52
4979A	1172(b)				52
	1854(a)		648		
4980	1132	234, 235		825	
	1132(a)				57
	1232		527		
4980(c)	1132(a)				52
4980A	1133	228, 231			
4981	668(a)			744, 745	41
	1133			823	
	1133(a)				57

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
4982	633(b)		413		
	651(a)			752	40
4991	255	65			
	1579(h)	321			
	1879(h)		659		
	1879(n)		660		
4991(e)	1879(h)				73
5061	1501(c)	270			
5703	1501(c)	270			
6012	104(a)				10
	1343	265			
	1525			920	
6012(a)	104(a)				10
6013(f)	1402	266			
	1708			934	
6031	1811(b)		624		44
6034A	1875(d)				44
6038A	986(c)		458		
6038A(b)	1245			879	69
6038A(c)	1245			879	
6039B	702(b)	179			
	1517		595		
6039C	952		463, 464		
	1510(f)	285			
6039C(d)	1810(f)		620, 622		
6039D	1151(h)			842	44
6039E	986(a)		451		
	986(b)		451		
	1234			874	
	1234(a)				69
6041(d)	1501(c)			916	44
6042(c)	501(c)		392		
	1501(c)				44
6044(e)	501(c)		392		
	1501(c)				44
6045	521(a)		391		
	1341	264			
	1521(a)			919	
6045(e)	1521(a)				44
6049	674				42
	1444		571, 576		
6049(c)	501(c)		392		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1501(c)				44
6049(d)	674			750	
6050E	145	264			
6050H	1511	289			
	1811(a)		624		44
6050K	1511	289			
	1811(c)		624		
6050M	522		391, 392		
	1342	264			
	1522			919	
	1522(a)				44
6050N	523		392		
	1523			919	44
6051(a)	1105(b)				54, 56
6052	1151(d)	241			
6091	972		477		
6091(b)	1879(r)				73
6103(b)	557(a)		399		
	1568			927	
6103(e)	1411(b)			914	
6109	1524(a)			920	
6109(e)	1524(a)				44
6111(c)	532(a)		393		
	1531			921	
	1531(a)				44
6152	1404(c)				47
	1614		598, 599		
6154	1542			922	45
	1542(a)				50
6154(c)	701(d)			754, 765	45
6166	1432				48
	1432(e)			915	
6212	1321	261			
	1562			926	46
6214	1554				46
6214(a)	543(a)		395		
	1554			924	
6229(g)	1881				44
6323	1569				46
6323(i)	1569			928	
6334	1324	262			
	1565				46

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
6334(a)	554(a)		398		
	1565			927	
6335	1570				46
6335(e)	1570			928	
6343(c)	1511(c)				44
6404	1322	261			
	1563			926	
6404(e)	552(a)		397		
	1563(a)				44
6405(b)	1579(e)	320			
	1879(e)		659		
6421	1703(c)			932	
6421(c)	1703(c)				73
6427	712		417, 418		
	1703(e)			932	73
6427(b)	1577(b)	319			
	1877(b)		657		73
6427(e)	422(b)			720	73
6427(h)	1703(d)			932	
6503	1235(d)				64
6511(d)	141(b)			683	
6601	1323	262			
	1332	263			
6601(a)	511(c)		391		
	1511(c)				44
6601(b)	512(a)		391		
	1512(a)				44
6601(c)	553(a)		398		
	1564			926	
	1564(a)				44
6611(a)	1511(c)				44
6611(f)	1575(c)	316			
	1875(c)		654		
6621	511		390, 391		
	511(b)		390, 391		
	1331	262			
	1511			918	
6621(a)	511(a)		391		
	1511(a)				44
6621(b)	511(a)		391		
	1511(a)				44
6621(c)	511(a)		391		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	511(c)		391		
	536(a)		393, 394		
	1535			922	
	1535(a)				44
6621(d)	511(c)		391		
6651	502		388		
	1302	258			
	1502				44
	1502(a)			917	
6651(c)	502(b)		389		
	1502(b)			917	
6651(d)	502(a)		388, 389		
6651(e)	502(a)		388, 389		
6652	1301	257			
	1351	265			
	1501		579, 587		
	1601(d)	329			
	1702(b)			932	
	1897(e)		672		
6652(a)	501(d)		388		
	1501(d)				44
6652(g)	952		463, 464		
	1510(f)	285			
	1810(f)		620, 621		72
6652(j)	1301(g)				30
	1702(b)				73
6652(k)	501(d)		388		
6652(l)	1151(b)			832	53
6653	142	36			
	503		389		
	503(d)		390		
	1303	258			
	1503			917, 918	
	1503(a)				44
6653(a)	503(a)		390		
6653(b)	503(a)		390		
6653(d)	503(c)		390		
6653(f)	503(c)		390		
6653(k)	503(d)		390		
6654	1311	259			
	1404				47
	1543			922	45

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1614		598, 599		
	1841				72
	1879(a)		658		45
6654(d)	561(a)		394		
	561(b)		394		
	1541			922	45
6654(i)	561(b)		394		
6654(j)	1841				45
6654(k)	1404				45
	1404(a)			912, 913	
6655	1543			922	45
	1879(a)		658		45
6659A	1138			828	
	1138(a)				54
	1139	236			
6660	1511	289			
	1811(d)		624		
6661	504		390		
6661(a)	1504			918	
	1504(a)				44
6662	531(a)		393		
6662N	531(a)		393		
6663	531(a)		393		
6673	1552			923	46
6676	501(b)		388		
	523(b)		392		
	1301	257			
	1524(b)			920	
6676(a)	1501(b)			916	44
6676(b)	1523(b)				44
6678	501(d)		388		
	1301	257			
	1501(d)				44
6693(b)	1102(d)			792	55
6697	667				41
	1437		567, 571		
6697(a)	667			744	
6699	1171(b)	246, 247			
6707(a)	533(a)		393		
	1532			921	
	1532(a)				44
6707(b)	534(a)		393		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1533			921	
	1533(a)				44
6708(a)	535(a)		393		
	1534			921	
	1534(a)				44
6710	1316	260			
6721	501		388		
	1301	257			
	1501				44
	1501(a)			916	
6722	501(a)		388		
	1301	257			
	1501				44
	1501(a)			916	
6723	501(a)		388		
	1301	257			
	1501				44
	1501(a)			916	
6724	501(a)		388		
	1301	257			
	1501				44
	1501(a)			916	
7325	1325	262			
	1566			927	46
7425	1572				46
7425(c)	1572			928	
7430	541		394, 395		
	1315	259			
	1551			922, 923	46
7443A	545		395		
	1556			924	
7447	546		396		
7447(b)	1557(a)			925	
7447(f)	1557(b)			925	
7448	546		396		
7448(c)	1559(a)			925	
7448(g)	1559(c)			925	
7448(m)	1557(c)			925	
	1559(b)			925	
7456(c)	545(b)		395		
7456(d)	545(b)		395		
7456(e)	544(a)		395		

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
	1555			924	
7471(c)	545(b)		395		
7472	542(b)		395		
7473	542(b)		395		
7474	542(b)		395		
7475	542		395		
	1553			924	46
7482	1558			925	46
7502	1511	289			
	1811(e)		624		
7508(b)	1402	266			
	1708			934	
7518	13	60			
	261			711, 712	29
7518(c)	701(a)				33
7518(e)	13	60			
7609	1561			925	46
7609(a)	656				40
7609(e)	556(a)		397		
7609(i)	556(b)		397		
7651	675	150, 152			
	975		477		
	1277(c)				70
7651(5)	1275(b)			887	
7652	1579(i)	321			
7652(g)	1879(i)				73
7654	676	150, 152			
	976		477		
	1276			887	70
7655	972		477		
7701	1151	237			
	1443		571, 577		
	1802		606		
7701(a)	671(b)				42
	1137			826	54
	1138	235, 236			
	1162	242			
	1166			844	51
	1236		528		
7701(b)	1510(l)	289			
	1810(l)		623, 624		72
7701(e)	1502(a)	272			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Internal Revenue Code §	Proposed or Final Act §	House Report (Vol. I Pg. No.)	Senate Report (Vol. I Pg. No.)	Conference Report (Vol. I Pg. No.)	Detailed Analysis (Vol. II Ch. No.)
7701(i)	673			751	
7701(j)	1147			830	
	1147(a)				54
7702	1825(f)		635, 636		
7702(e)	1525(a)	298			
	1825(a)		634		75
7702(f)	1525(b)	298			
	1825(b)		634		75
7702(g)	1525(c)	299			
	1825(c)		635		75
7852	2	26			
7853	2	26			
7872	1512(b)	289			
	1812(b)		624, 625		
7872(f)	1812(b)				31
9505	558		396		
	1403	266			
10640	1211	249, 252			

© Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.